Supreme Court, U.S.
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No. _____

In the

Supreme Court of the United States

October Term, 1998

IRENE L. WRIGHT, on behalf of herself
and all others similarly situated,

Petitioner,

-v-

ERNST & YOUNG LLP,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Can a secondary actor not identified in a public statement incur primary liability under Section 10(b) of the Securities Exchange Act of 1934 where he communicates false information to an issuer knowing that the issuer will publish that information?

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CITATIONS OF OPINIONS AND ORDERS

The opinion of the United States Court of Appeals for the Second Circuit in the matter of Irene L. Wright, on behalf of herself and all others similarly situated, Plaintiff-Appellant v. Ernst & Young LLP, a New York corporation, Defendant-Appellee, 152 F.3d 169 (2d Cir. 1998), is set forth at Appendix, p. 1a.

The Order of the United States District Court for the Southern District of New York dismissing the complaint is set forth at Appendix, p. 20a.

BASIS FOR JURISDICTION IN THIS COURT

The Judgment of the United States Court of Appeals for the Second Circuit was entered on August 6, 1998.

There has been no order requesting rehearing or granting an extension of time to file the petition for a writ of certiorari.

This Court has jurisdiction to review the judgment in question on a writ of certiorari pursuant to 28 U.S.C. § 1254.

STATUTE IN QUESTION

The federal statute involved is 15 U.S.C. § 78(j), commonly referred to as section 10(b) of the Securities Exchange Act of 1934, which is set out verbatim at Appendix, p. 27a.

STATEMENT OF THE CASE

This action (the "Action") was brought as a class action to remedy alleged violations by defendant Ernst & Young LLP ("E&Y") of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), on behalf of purchasers of BT Office Products International Inc. ("BT" or the "Company") common stock between January 30, 1996 (the date BT published its 1995 full year and fourth quarter financial results based on defendant E&Y's representations to BT's management as to their accuracy), through March 28, 1996 (when BT revealed that the previously announced 1995, as well as 1994, financial results were materially misstated), inclusive (the "Class Period"), who were damaged thereby (the "Class").

Plaintiff claims that defendant E&Y, the Company's outside auditor, violated the Exchange Act by affirmatively telling the Company that its financial results for its fiscal year ended December 31, 1995, were sufficiently accurate for dissemination to the investing public. Plaintiff further alleges that E&Y assured BT that it could publicly disseminate the subject financial results in a press release despite E&Y's knowledge of myriad and substantial violations of Generally Accepted Auditing Standards ("GAAS") and despite learning in January 1996 that the Company had an unexplained $3,900,000 under-accrual in accounts payable at 1995 year-end.

The parties all agree that BT's 1995 financial results published on January 30, 1996, as well as the Company's 1994 financial statements, were false. At issue in this case was whether defendant E&Y, which was directly or indirectly

responsible for the publication of those false financial results, is liable under Section 10(b).

On September 10, 1997, without entertaining oral argument, United States District Court Judge for the Southern District of New York Shira A. Scheindlin issued her opinion and order dismissing the case, holding that defendant E&Y's oral assurances to BT that the 1995 figures were accurate and that its just-completed field work complied with GAAS did not constitute an actionable misstatement.

The United States Court of Appeals for the Second Circuit affirmed the District Court on August 6, 1998. The Second Circuit held that E&Y could not be liable for misstatements contained in the press release published by BT because E&Y was not identified in that press release as having made any statement and, therefore, the market did not rely on the conduct of E&Y.

The bases for federal jurisdiction in the District Court for the Southern District of New York, the federal court of first instance, were 15 U.S.C. § 78aa and 28 U.S.C. § 1331.

ARGUMENT IN SUPPORT OF PETITION

Since this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), holding that no claim existed for aiding and abetting under Section 10(b) of the Exchange Act, federal district and circuit courts have struggled to determine the boundaries of primary liability under the Exchange Act for parties other than the

actual speaker. *Central Bank* simply states that the Exchange Act "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 511 U.S. at 177. Seizing on this language, some courts have read the *Central Bank* decision to mean that there can be no liability if a defendant does not actually make the public statement. Other courts have interpreted the decision less restrictively to mean that a defendant must, in some way, be responsible for a misstatement.

Further complicating matters, at least two Circuit Courts of Appeal have offered differing views about what it means to "make" a public statement. In *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996), the Tenth Circuit held that a statement uttered *indirectly* to the public may give rise to liability under Section 10(b), but the Second Circuit in this Action has now held to the contrary -- that a misstatement could only serve as the basis for liability if *publicly attributed* to the alleged wrongdoer, thereby seeming to contradict the holding of *Anixter*. The Second Circuit held that: "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination." *Wright* at Appendix, p. 12a. The Second Circuit explained that to hold otherwise would effectively eviscerate the requirement of reliance as an element of a claim under Section 10(b) of the Exchange Act.[1]

---

[1] In fact, plaintiff here alleged implicit reliance on E&Y because the market knew that a public company such as BT would not publish its year-end results until the accountants had completed their field work and authorized the publication of these results. The market further knew that BT's accountants were E&Y because they were the auditors on BT's initial public offering in July 1995 and there had been no announcement of any change in auditors. Thus, E&Y, although not specifically identified as such here, was clearly the known indirect speaker.

However, as discussed in detail below, the Third Circuit, in a remarkably similar case involving attorneys' liability under the Exchange Act, recently held that direct attribution is unnecessary to plead reliance in a 10b-5 case, thus supporting the *Anixter* formulation. *See Klein v. Boyd* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90, 136 (3d Cir. Feb. 12, 1998). That decision has been vacated by the full panel and is currently under *en banc* review with rehearing scheduled for November 23, 1998. *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90, 165 (3d Cir. Mar. 9, 1998).

The Third Circuit explained that its holding was in no way inconsistent with *Central Bank* or *Anixter* because it agreed that a defendant must make a statement for Section 10(b) liability to attach. *Klein*, (CCH) ¶ 90,136 at 90,325. Simply, the Third Circuit found, contrary to the Second Circuit's ruling in *Wright*, that a secondary actor's involvement in creating a false statement may be "so significant that the secondary actor can fairly be said to have made the statement," albeit indirectly. *Id.* at 90,326 n.7.

Thus, review should be granted here to resolve the confusion and inconsistent rulings amongst the Circuits interpreting this Court's decision in *Central Bank* as to the extent a secondary actor may be liable for making or participating in the making of false statements when the secondary actor is not specifically identified in the misstatement.

Can a secondary actor not identified in a public statement incur primary liability under Section 10(b) of the Exchange Act where he communicates false information to an issuer knowing that the issuer will publish that information?

In *Central Bank*, this Court enunciated the narrow rule "that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." 511 U.S. at 191. The Court expressly noted, however, that its ruling did not insulate accountants, such as defendant E&Y here, from liability under Section 10(b), stating:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, *accountant*, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. (first emphasis added). Determining what actions support primary liability for secondary actors has thus been left to *Central Bank*'s progeny. District courts interpreting *Central Bank* have generally followed one of two approaches in analyzing potential claims. Several courts have adopted a bright line test that a person must actually make the allegedly false or misleading statement for primary liability to attach under Section 10(b). *See, e.g., In re JWP Inc. Securities Litigation*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996); *In re Kendall Square Research Corp. Securities Litigation*, 868 F. Supp. 26, 28 (D. Mass. 1994); *O'Neil v. Appel*, 897 F. Supp. 995, 999 (W. D. Mich. 1995); *Vosgerichian v. Commodore International*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994).

Other courts have adopted the view that a person who lends substantial assistance to the preparation of a false statement of another may also be held primarily liable. *See, e.g., Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 316 (S.D.N.Y. 1996); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432-34 (N.D. Ill. 1995); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *Whirlpool Financial Corp. v. GN Holdings, Inc.*, 873 F. Supp. 111, 119 (N.D. Ill. 1995); *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960, 972 (C.D. Cal. 1994).

More recently, the Second, Ninth, and Tenth Circuit Courts of Appeal have provided their interpretations of *Central Bank* resulting in three different standards. In *Anixter*, the Tenth Circuit held that "[t]here is no requirement that the alleged violator directly communicate misrepresentations to plaintiffs for primary liability to attach." 77 F.3d at 1226 (citing *SEC v. Holschuh*, 694 F.2d 130, 142 (7th Cir. 1982) ("[A]ctual or first-hand contact with offerees or buyers [is not] a condition precedent to primary liability for antifraud violations.")). The *Anixter* court explained that an accountant may be liable for misrepresentations not made directly to the public so long as there is a "showing that [it] knew or should have known that [its] representation would be communicated to investors ...." 77 F.3d at 1226.

This interpretation appears to be supported by *Central Bank* itself which foreclosed Section 10(b) liability from extending to aiding and abetting, because "aiding and abetting liability extends beyond persons who engage, *even indirectly*, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all,

but who give a degree of aid to those who do." 511 U.S. at 176 (emphasis added).

The Ninth Circuit, in *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994), endorsed an even more liberal test, holding that a secondary actor, such as an accountant, may be primarily liable under Section 10(b) where it played a "significant role" in the dissemination of misleading statements. This "substantial participation" test, as it has come to be known, has been rejected by the Second Circuit. *See, e.g., Shapiro v. Cantor*, 123 F.3d 717, 721-22 (2d Cir. 1997). Nevertheless, different panels of the Second Circuit have rendered three decisions, in addition to *Wright*, which are inconsistent in their interpretation of *Central Bank*, indicating that the time is ripe for this Court to clarify its decision in *Central Bank*.

In *SEC v. First Jersey Securities Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996), the Second Circuit explained that "[p]rimary liability may be imposed 'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'" (citing *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994)). However, in *Shapiro*, the Second Circuit appeared to foreclose the notion that liability could attach to anyone but the speaker when it cited with approval the language from *In Re MTC Electronic Technologies Shareholders Litigation*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995), stating that if *Central Bank*:

> [I]s to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under

> Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

Shapiro, 123 F.3d at 720.

To further confuse the landscape, more recently, the Second Circuit, in *SEC v. U.S. Environmental, Inc.*, 1998 U.S. App. LEXIS 21416, at *13-14 (2d Cir. Aug. 25, 1998), appears to have retreated from this hard line, acknowledging that one who commits a manipulative and deceptive act may still be primarily liable under Section 10(b) even if he does not make an affirmative misstatement.

Against this backdrop we turn to the *Wright* case where the Second Circuit apparently rejected *Anixter*'s indirect misstatement theory by holding that reliance is a determinative element in examining whether a third party is liable for making a false statement.

Plaintiff alleges that E&Y, as the outside auditor responsible for approving the accuracy of BT's year-end financial statements, made an actionable affirmative misrepresentation when it orally told BT's Chief Financial Officer that the Company's year-end financial statements were sufficiently accurate for dissemination to the public. As plaintiff's Complaint alleges, E&Y and the market knew that the Company's public release of the year-end figures was contingent on receiving approval from E&Y. In affirming the District Court's dismissal, the Second Circuit, citing *Anixter* 77 F.3d at 1226-27, noted that a misstatement need not be

communicated directly to the public for Section 10(b) liability to attach. Nevertheless, it disregarded that standard by holding that the offending misrepresentation must attribute some misstatement to a particular party for that party to be liable. "[T]he misrepresentation must be attributed to that specific actor at the time of public dissemination, it simply requires that the statement be identified as to time and place, that is, in advance of the investment decision." *Wright* at Appendix, p. 12a. According to the Court, the reasoning of this holding is rooted in the concept of reliance. However, the Complaint does allege that the market knew by implication that E&Y had approved the publication of this false statement.

Plaintiff respectfully submits that the Second Circuit confused the requirement that a plaintiff (or the market) rely on a misstatement with the notion that there must be direct reliance on the misconduct of that particular party. By reaching this holding, the Second Circuit effectively eliminated liability for any indirect misstatements by a party no matter the degree of culpability of that party in perpetrating a fraud on the public. In *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960 (C.D. Cal. 1994), the Central District of California addressed this very issue and explained why the market need not be cognizant of who was responsible, even indirectly, for the misleading information that was relied upon:

> While the investing public may not be able to reasonably attribute the additional misstatements and omissions to E&Y, the securities market still relied on those public statements and anyone intricately involved in

> their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5.

Id. at 970.

Commentators have also explained that a defendant's role in perpetrating a fraud is not excused simply because his misstatements have only indirectly reached the marketplace:

> The reliance that a plaintiff must establish to recover on a Section 10(b)/Rule 10b-5 participation claim is reliance upon the false representation, not upon any particular defendant's role in preparing it. Indeed, it is irrelevant that the plaintiff, at the time of reliance upon the misrepresentation, does not know the identities of all who had a significant role in preparing it. At common law and in pre-Brennan Section 10(b)/Rule 10b-5 jurisprudence, all who played a substantial role in the preparation were potentially primarily liable, even if their identities did not become known until after the transaction.

Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 757, n. 293 (1997).

Similarly, as explained by Donald C. Langevoort, *Words From on High About Rule 10B-5: Chiarella's History, Central Bank's Future*, 20 Del. J. Corp. L. 865 (1995), the securities laws are designed to prohibit all fraudulent conduct:

> There is little sense, however, in limiting fraud liability to those whose involvement is public and direct. The vast bulk of securities law makes clear that behind the scenes involvement in fraudulent disclosure (or actionable nondisclosure), as opposed to mere participation in the fraud, by no means absolves the participant from culpability. The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to the victim.

Id. at 889.

In fact, this very issue is now under consideration by the Third Circuit Court of Appeals in its *en banc* review of *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998). In *Klein*, which was vacated by a majority of the Third Circuit after granting defendant's petition for a rehearing, *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. ¶ 90,165 (3d Cir. Mar. 9, 1998), plaintiff alleged that the law firm of Drinker Biddle was liable under Section 10(b) for its role in disseminating disclosure documents in connection with a limited partnership investment even though the firm did not sign the documents nor did its name appear anywhere on the documents. Initially, the district court granted defendant's summary judgment motion, reasoning, in part, that because investors did not know of Drinker Biddle's involvement in the limited

partnership they could not have relied upon any of the firm's representations. The Third Circuit disagreed, stating:

> We conclude that lawyers and other secondary actors who significantly participate in the creation of their client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors of those misrepresentations, should be held accountable as primary violators under section 10(b) and Rule 10b-5 *even when the lawyers or other secondary* actors are not identified to the investor, assuming the other requirements of primary liability are met.

(CCH) ¶ 90,136 at 90,324 (emphasis added).

The Court of Appeals went on to explain that:

> Section 10(b) and Rule 10b-5 require the plaintiff to demonstrate reliance on the misleading statement; they do not require the plaintiff to demonstrate that he or she relied on the *defendant's role* in the preparation or dissemination of the statement. When an investor reasonably relies on a materially misleading statement in connection with the purchase or sale of a security, the author of the statement should not be allowed to escape liability under the federal securities laws merely because the author is unknown to the investor.

Id. (second emphasis added).

The Third Circuit made clear that it was not endorsing the Ninth Circuit's "substantial assistance" test. Rather, when a person's participation in the creation of a document containing a misrepresentation is such that the person can be deemed an author or co-author of the document liability may attach.[2] "This is true even if the investor is unable to attribute the statement to the person at the time of the transaction." *Id.* at 90,325.

Here, plaintiff alleges that defendant actually made a misstatement, albeit orally. Defendant E&Y proposed and subsequently told BT that its year-end financials were accurate and could be published. E&Y knew that, based upon that representation, BT would, in fact, issue those figures to the public. Plaintiff has alleged that but for this representation the figures would not have been disseminated to the public. Certainly had the press release circulated by BT affirmatively stated that E&Y approved the release of year-end figures, there would be no question as to E&Y's liability. Thus, the only issue is one of direct attribution, an issue currently being examined by the Third Circuit, and one which petitioner believes merits consideration by this Court as well.

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[2] Of course, for this reason, the decision may be at odds with the Second Circuit opinions of SEC *v. First Jersey Securities, Inc.*, 101 F.3d 1450 (2d Cir. 1996), and SEC *v. U.S. Environmental, Inc.*, No. 97-6195, 1998 U.S. App. LEXIS 21416 (2d Cir. Aug. 25, 1998), cited above, which found liability even absent the making of a statement.

CONCLUSION

As the Second Circuit itself stated in *Wright*, "[i]n the wake of *Central Bank*, federal courts have differed over the threshold required for a secondary actor's conduct to implicate primary liability." Appendix, p. 10a. Now, two Circuit Courts of Appeal, in attempting to apply the same "threshold," differ over the issue of whether a statement must be directly attributed to a defendant for Section 10(b) liability to apply.

This Court's seemingly narrow holding in *Central Bank*, that aiding and abetting allegations no longer are actionable under Section 10(b), has been stretched thin through interpretation by the lower courts. This petition presents the Court with an opportunity to clarify the limits of *Central Bank*.

WHEREFORE, petitioner requests that this Court grant the petition for a writ of certiorari and reverse the Second Circuit in *Wright*.

Respectfully Submitted,

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U.S. 2nd Circuit Court of Appeals

WRIGHT v ERNST & YOUNG LLP

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 1997

(Argued April 27, 1998 Decided August 6, 1998)

Docket No. 97-9241

IRENE L. WRIGHT, on behalf of herself and all others similarly situated,

Plaintiff-Appellant,

v.

ERNST & YOUNG LLP,

Defendant-Appellee.

Before: VAN GRAAFEILAND, MESKILL and CABRANES, Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Scheindlin, J., dismissing a class action complaint against an accounting firm, alleging fraud in connection with the sale of securities, pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim on which relief could be granted.

Affirmed.

DAVID A.P. BROWER, Wolf Haldenstein Adler Freeman & Herz, New York City (Daniel W. Krasner, Wolf Haldenstein Adler Freeman & Herz, New York City, Charles J. Piven, Baltimore, MD, of counsel),

for Appellant.

BRUCE M. CORMIER, Associate General Counsel, Ernst & Young LLP, Washington, D.C. (Michael J. Crane, Assistant General Counsel, Ernst & Young LLP, New York City, Robert J. Ward, Mayer, Brown & Platt, New York City, Michele Odorizzi, Mayer, Brown & Platt, Chicago, IL, of counsel),

for Appellee.

MESKILL, Circuit Judge:

Plaintiff-appellant Irene Wright appeals from a final judgment rendered in the United States District Court for the Southern District of New York, Scheindlin, J., dismissing her amended class action complaint charging defendant accounting firm Ernst & Young LLP with making materially false representations in connection with BT Office Products' sale of common stock, all in violation of § 10(b) of the Securities Exchange Act of 1934 (the Act), 15 U.S.C. § 78j(b), and Securities and Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5. See Wright v. Ernst & Young LLP, 1997 WL 563782 (S.D.N.Y. Sept. 10, 1997). The district court dismissed the amended complaint pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim on which relief could be granted, but sua sponte granted leave to replead. The plaintiff-appellant declined to replead and instead filed this appeal, asserting that the amended complaint adequately stated a cause of action for violation of federal securities law. The question we must answer is whether, under the Act,

persons who purchase stock in a company that issued a press release containing false and misleading financial information, with a notation that the information is unaudited and without mention of its outside auditor, can recover from the auditor for its private approval of the information contained in the press release. We conclude that under these circumstances, primary liability is foreclosed by Central Bank of Denver v. First Interstate Bank of Denver, (1994), and by our recent decision in Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997). Accordingly, we affirm the judgment of the district court dismissing the amended complaint.

BACKGROUND

The appellee, Ernst & Young LLP (Ernst & Young or the firm), is a firm engaged in the business of providing various accounting services, including auditing and financial analysis. At all relevant times, Ernst & Young was the outside auditor for BT Office Products, Inc. (BT), a corporation engaged in the distribution and sale of office products. The gravamen of the amended complaint is that Ernst & Young violated the antifraud provisions of the Act by orally approving BT's materially false and misleading financial statements that BT in turn disseminated to the public in a January 30, 1996 press release. Plaintiff- appellant Irene Wright (Wright) represents a class of investors who purchased BT common stock during the period between BT's January 30, 1996 press release and BT's public statement on March 28, 1996 disavowing the financial statements

<:f, Carnegie,>contained in that release (the class period). Wright claims that because "the market knew and relied on the fact that these financial statements were approved by [Ernst & Young]," Ernst & Young is liable for losses suffered once BT's true financial picture emerged. Wright also filed a class action suit in the Southern District of New York against

BT alleging securities fraud in connection with the same set of circumstances. In March 1997, the class reached a settlement with BT under which the company agreed to pay $1,480,000 to the class.

As set forth in the amended complaint against Ernst & Young, BT embarked on a series of acquisitions in 1987, including the purchase of a stationer known as Summit Office Supply (BT-Summit). As BT expanded, its management decided to engage Ernst & Young to audit its year-end financial statements. Ernst & Young issued audit opinions certifying the accuracy of BT's financial statements for the years ending December 31, 1993 and December 31, 1994. Later, in July 1995, the firm updated and re-released the December 31, 1994 audit opinion as a "Report of Independent Auditors" for use in BT's initial public offering prospectus, which included a statement of BT's first quarter earnings for 1995. The audit upon which that report was based included a "full-scope" audit of several BT subsidiaries, but only a "limited review" of BT-Summit's accounts.

In the fall of 1995, the firm began a new "full-scope" audit of BT-Summit. Pursuant to this effort, it discovered an under-accrual of BT-Summit's accounts payable and alerted BT management. Upon consideration, however, Ernst & Young concluded that the under-accrual was not material and advised BT that it was probably a carryover of a similar under-accrual from the year before. Accordingly, the amended complaint avers that "on January 22, 1996 [Ernst & Young] signed off on BT Office Products' 1995 financial statements . . . and authorized [BT] to release its 1995 year end results with full knowledge of the fact that the market would and did interpret the release of these figures as having been approved by [Ernst & Young]." The amended complaint further states that based on Ernst & Young's oral assurances, BT

issued a press release on January 30, 1996 that set forth BT's 1995 financial results and indicated strong growth during 1995. The press release also stated, however, that the figures were "unaudited" and it made no mention of Ernst & Young.

In late February and March of 1996, it became apparent to both BT and Ernst & Young that the under-accrual problem at BT-Summit was more serious than previously believed. A further investigation revealed not only that BT-Summit employees used improper accounting techniques, but substantial company funds had been embezzled. In light of these discoveries, BT announced on March 28, 1996 that it was restating its 1995 financial results from a previously announced profit of $1.5 million to a loss of $200,000. With that announcement, BT's stock lost more than 25% of its value, injuring Wright and the other class members.

The amended complaint alleges that "due to [the firm's] recklessness and failure to follow Generally Accepted Auditing Standards (`GAAS') [Ernst & Young, by electing to perform only a limited review of BT-Summit,] did not uncover the massive `accounting and financial reporting irregularities' at BT-Summit." Allegedly because of this recklessness, Wright and other class members purchased stock at an artificially inflated price and later suffered injury once BT's true financial picture emerged.

In the proceedings before Judge Scheindlin, Ernst & Young filed a motion to dismiss, arguing, inter alia, that because it did not itself make any false statement to the public, the amended complaint alleged nothing more than "aiding and abetting" liability, a form of Rule 10b-5 liability that the Supreme Court abolished in Central Bank of Denver v. First Interstate Bank of Denver, (1994). In opposing that motion, Wright argued that the amended complaint properly alleged

a 10b-5 violation because it alleged that Ernst & Young provided false and misleading advice to BT, knowing that the advice would be passed on to investors. Moreover, because Ernst & Young allegedly "signed-off" or approved the financial information within that press release, Wright averred that the market understood the press release as an implied statement by Ernst & Young that the financial information contained therein was accurate. In reply, Ernst & Young pointed out that BT's January 30, 1996 press release did not purport to repeat any statement made by Ernst & Young and that the press release expressly stated that the 1995 financial results were "unaudited."

On September 9, 1997 Judge Scheindlin granted the motion to dismiss. In doing so, she rejected Wright's argument that BT's press release constituted an implied statement to the public that Ernst & Young had approved BT's financial statements, noting that such a claim was refuted by BT's statement in the press release that the 1995 financial results were "unaudited." See Wright, 1997 WL 563782, at *2. Further, the court observed that transforming that disclaimer into a guarantee of the statement's accuracy would "seriously deter disclosure of unaudited financial information." Id. The court also observed that sustaining the amended complaint in light of Ernst & Young's "clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in Central Bank." Id. at *3. Finally, Judge Scheindlin concluded that although the amended complaint also alleged misstatements by Ernst & Young in connection with BT's 1995 initial public offering prospectus, the amended complaint failed to allege fully a § 10(b) cause of action on that ground. Id. at *4. Accordingly, the court sua sponte granted Wright leave to cure the defects by filing a second amended complaint by September 29, 1997. Wright

did not file a second amended complaint and accordingly, the district court entered judgment on September 30, 1997. Wright filed a notice of appeal on October 1, 1997.

DISCUSSION

On appeal, Wright argues that the district court (1) erred in holding that the amended complaint failed to allege that Ernst & Young made an actionable misstatement within the meaning of the Act; (2) erred in crediting the "unaudited" disclaimer in BT's press release and thus erred in rejecting her allegation that the market understood the press release as an implied statement by Ernst & Young that the financial information contained therein was accurate; and (3) erred in dismissing the amended complaint because, at the very least, it stated a cause of action for failure to correct misstatements in the 1995 initial public offering prospectus.

We review de novo the district court's dismissal of a complaint under Fed. R. Civ. P. 12(b)(6), taking all well-pleaded factual averments in the complaint as true and drawing all reasonable inferences in the plaintiff's favor. See Leeds v. Meltz, 85 F.3d 51, 53 (2d Cir. 1996). "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." Scheuer v. Rhodes, (1974).

1. Actionable Statements and § 10(b)

Wright first argues that because a defendant can incur primary liability under the Act for false statements that are not directly communicated to the public, there is no requirement that the false statement be attributed to the defendant at the time of its dissemination. Thus, Wright maintains that

although BT's press release attributes no statement to Ernst & Young, the amended complaint nevertheless alleges a false statement within the meaning of § 10(b) because it alleges that Ernst & Young "assured" BT of the accuracy of its 1995 financial results, knowing that BT would, in turn, promptly disseminate those results to investors in the press release.

Further, Wright argues that even if the amended complaint does not allege conduct amounting to a false statement, it does state a § 10(b) cause of action under post-Central Bank authority because Ernst & Young is alleged to have "substantially participated" in the fraud. See SEC v. First Jersey Securities, 101 F.3d 1450, 1471 (2d Cir. 1996) ("Primary liability may be imposed `not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'" (citation omitted)), cert. denied, 118 S.Ct. 57 (1997); see also In re Software Toolworks Inc. Sec. Litigation, 50 F.3d 615, 628 n.3 (9th Cir. 1994), cert. denied, (1995); In re ZZZZ Best Sec. Litigation, 864 F.Supp. 960, 970 n.12 (C.D. Cal. 1994). We disagree on both counts.

We conclude that Wright's arguments are foreclosed by Central Bank and by our recent decision in Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997). Section 10(b) of the Act provides in pertinent part:

It shall be unlawful for any person, directly or indirectly . . .

. . . .

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in

> contravention of such rules and regulations as the [SEC] may prescribe.

15 U.S.C. § 78j (emphasis added). Its parallel regulation, SEC Rule 10b-5 provides in pertinent part:

It shall be unlawful for any person, directly or indirectly . . .

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (emphasis added). Prior to the Supreme Court's decision in Central Bank, a number of federal courts held that the strictures of § 10(b) reached not only those who actually make a material misstatement, but also those who aid and abet such a violation. See Central Bank, (citing Brennan v. Midwestern United Life Ins. Co., 259 F.Supp. 673 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969), cert. denied, (1970); Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); Kerbs v. Fall River Indus., 502 F.2d 731, 740 (10th Cir. 1974)). However, after the Supreme Court's strict adherence to the text of § 10(b) in such cases as Santa Fe Indus. v. Green, (1977), and Ernst & Ernst v. Hochfelder, (1976), courts and commentators began to question the viability of secondary liability claims under § 10(b). See Central Bank, -70 (citing Daniel R. Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 Calif. L. Rev. 80, 82 (1981); Benoay v. Decker, 517

F.Supp. 490, 495 (E.D. Mich. 1981), aff'd, 735 F.2d 1363 (6th Cir. 1984)).

In Central Bank, the Supreme Court addressed the legitimacy of secondary liability claims in private actions brought pursuant to § 10(b). The Court concluded from the text of the Act that Congress never intended to impose secondary liability under § 10(b) and thus the Act "does not itself reach those who aid and abet . . . [but] prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." Central Bank, . The Court further observed that authorizing a § 10(b) cause of action based on aiding and abetting would circumvent the "reliance" requirement of Rule 10b-5 by allowing a plaintiff to prevail "without any showing that the plaintiff relied upon the aider and abettor's statements or actions." Id. at 180; see also Basic v. Levinson, (1988) (rejecting liability under Rule 10b-5 without reliance). However, the Court did not hold that secondary actors are always free from liability under the Act. Rather, secondary actors like accountants may be held liable as primary violators if all the requirements for primary liability are met, including "a material misstatement (or omission) on which a purchaser or seller of securities relies." Central Bank, .

In the wake of Central Bank, federal courts have differed over the threshold required for a secondary actor's conduct to implicate primary liability. As Judge Gleeson of the Eastern District of New York observed,

> [s]ome courts have held that a third party's review and approval of documents containing fraudulent statements is not actionable under Section 10(b) because one must make the material misstatement or omission in order to be a primary violator. See, e.g., In

> re Kendall Square Research Corporation Securities Litigation, 868 F.Supp. 26, 28 (D. Mass. 1994) (accountant's "review and approval" of financial statements and prospectuses insufficient); Vosgerichian v. Commodore International, 862 F.Supp. 1371, 1378 (E.D. Pa. 1994) (allegations that accountant "advised" and "guid[ed]" client in making allegedly fraudulent misrepresentations insufficient).
>
> Other [courts] have held that third parties may be primarily liable for statements made by others in which the defendant had significant participation. See, e.g., In re Software Toolworks, 50 F.3d 615, 628 n. 3 (9th Cir. 1994) (accountant may be primarily liable based on its "significant role in drafting and editing" a letter sent by the issuer to the SEC); . . . In re ZZZZ Best Securities Litigation, 864 F.Supp. 960, 970 (C.D. Cal. 1994) (an accounting firm that was "intricately involved" in the creation of false documents and their "resulting deception" is a primary violator of section 10(b)).

In re MTC Elec. Technologies Shareholders Litigation, 898 F.Supp. 974, 986 (E.D.N.Y. 1995) (second alteration in original). These two differing approaches have been characterized respectively as the "bright line" test and the "substantial[] participat[ion]" test. Id.; see also Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996).

In Shapiro, we followed the "bright line" test after observing that "`[i]f Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).'" Shapiro, 123 F.3d at 720 (quoting In re MTC Elec. Technologies Shareholders Litigation,

898 F.Supp. at 987). We also observed that because § 10(b) and Rule 10b-5 focus on fraud made in connection with the sale or purchase of securities, a defendant must "`know or should know'" that his representation would be communicated to investors. Id. at 720 (quoting Anixter, 77 F.3d at 1226). "There is no requirement that the alleged violator directly communicate misrepresentations to [investors] for primary liability to attach." Anixter, 77 F.3d at 1226. However, contrary to Wright's argument, a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the Act, as "[r]eliance only on representations made by others cannot itself form the basis of liability." Id. at 1225. Thus, the misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision. See In re Kendall Square Research Corp. Sec. Litigation, 868 F.Supp. at 28 (where accountant did not issue a report on the company's financial statements, but merely "reviewed and approved" them, the accountant could not be liable for a material misstatement); see also 5 Alan R. Bromberg & Lewis D. Lowenfels, Bromberg and Lowenfels on Securities Fraud & Commodities Fraud, § 8.56, at 336 (New Matter) (2d ed. 1996) (in the aftermath of Central Bank, "accountants whose reports appear[] in an otherwise fraudulent document[]" may incur primary liability under the Act) (emphasis added).

In this case, BT's press release did not attribute any assurances to Ernst & Young and, in fact, did not mention Ernst & Young at all. Thus, Ernst & Young neither directly nor indirectly communicated misrepresentations to investors. Therefore, the amended complaint failed to allege that Ernst & Young made "a material misstatement (or omission) on which a purchaser or seller of securities relie[d]." Central

Bank, . Moreover, as the district court aptly recognized, because the press release contained a clear and express warning that no audit had yet been completed, there is no basis for Wright to claim that Ernst & Young had endorsed the accuracy of those results. We therefore agree with the district court that holding Ernst & Young primarily liable under the Act "in spite of its clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in Central Bank." Wright, 1997 WL 563782, at *3.

Wright also argues that under the post-Central Bank authority of this Circuit, the amended complaint nevertheless states a cause of action because Ernst & Young is alleged to have "substantially participated" in the fraud. Specifically, Wright cites our decision in First Jersey, 101 F.3d at 1471, for the proposition that "[p]rimary liability may be imposed `not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'" Id. (quoting Azrielli v. Cohen Law Offices, 21 F.3d 512, 517 (2d Cir. 1994)). Wright's argument is unpersuasive.

In First Jersey, we affirmed the imposition of primary liability under § 10(b) on Robert Brennan, the president, chief executive and sole owner of First Jersey Securities, Inc. Brennan had directed his employees to make false and misleading statements to customers. We held Brennan liable for securities fraud in his capacity as a "controlling person," that is, for fraud planned and directed by upper level management. Id. at 1471-74. Here, we confront alleged fraud by accountants -- secondary actors who may no longer be held primarily liable under § 10(b) for mere knowledge and assistance in the fraud. See Central Bank, ; see also IIT v. Cornfeld, 619 F.2d

909, 922 (2d Cir. 1980) (knowledge and substantial assistance are two of the three prongs for pre- Central Bank aiding and abetting liability).

In 1995, Congress authorized the SEC to bring enforcement actions against those who "knowingly provide[] substantial assistance to another person" in violation of the federal securities laws. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737, 757, codified in 15 U.S.C. § 78t(f). That congressional act did not create a private cause of action.

Finally, Wright argues that we should follow other jurisdictions that have adopted the substantial participation test. See In re Software Toolworks Inc. Sec. Litigation, 50 F.3d at 628 n.3; In re ZZZZ Best Sec. Litigation, 864 F.Supp. at 970 n.12. We decline to do so. See Shapiro, 123 F.3d at 720. Moreover, even under the "substantial participation" test, we would be hard pressed to conclude that the amended complaint alleged an actionable misrepresentation within the meaning of § 10(b). See Cashman v. Coopers & Lybrand, 877 F.Supp. 425, 432 (N.D. Ill. 1995) (where court applies substantial participation test, accounting firm may not incur primary liability for a misstatement unless that statement is "certified, audited, prepared or reported"); see also Robin v. Arthur Young & Co., 915 F.2d 1120, 1125 (7th Cir. 1990) (accounting firm could not be held liable for aiding and abetting under pre-Central Bank standard even where company alleged that "but for" accounting firm's consent, company would not have issued prospectus containing false and misleading financial statements), cert. denied, (1991).

2. The "Unaudited" Disclaimer

Wright next argues that the district court erred in giving effect to BT's disclaimer in the press release which stated that

the financial results were "unaudited." Wright prays that by rendering that disclaimer ineffective, we might breathe new life into her averment that the market understood BT's press release as an implied assertion by Ernst & Young that BT's financial statements were accurate. Specifically, Wright argues that the district court (a) erred in relying on the "bespeaks caution doctrine" in crediting that disclaimer; (b) erred in resolving disputed facts regarding what the market would implicitly understand by a company's release of financial results and an accountant's role in that release; (c) erred in giving effect to the word "unaudited" when such a disclaimer cannot negate Ernst & Young's own pivotal conduct in causing the dissemination of the false financial results; and (d) erred by allowing accountants to hide behind the word "unaudited," in contravention to the broad remedial purposes of the Act.

Wright cannot prevail regardless of how we treat the disclaimer. As noted, Ernst & Young's assurances were never communicated to the public either directly or indirectly. BT issued the press release without a whisper of Ernst & Young's involvement. Thus, in order to resurrect Wright's claim that Ernst & Young made an actionable statement within the meaning of § 10(b), we would have to do more than just refuse to give effect to the "unaudited" disclaimer. We would also have to ignore the absence of any mention of Ernst & Young in BT's press release and focus instead on what the market might have implicitly "understood" about Ernst & Young's involvement in that press release. In other words, we would have to grant Wright an exception to the rule established by the Supreme Court that secondary actors such as accountants may not be held primarily liable unless they themselves have made "a material misstatement (or omission) on which a purchaser or seller of securities relies." Central Bank, . We find no justification for granting such an exception. See, e.g., In re Fidelity/Micron Sec. Litigation, 964

F.Supp. 539, 543-44 (D. Mass. 1997) (holding that a mutual fund, Magellan, cannot be held primarily liable on a theory of respondeat superior for the alleged misstatements of its fund manager, notwithstanding plaintiff's contention "`that the market understood that [the fund manager] spoke for Magellan'" (emphasis added)). We also perceive no affront to the remedial purposes of the Act. While the Act does carry broad remedial purposes, the Act may not be "amend[ed] . . . to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." Central Bank, -78 (emphasis added). Aiding and abetting liability is simply not covered by the Act. Accordingly, we conclude that the district court did not err in so holding.

3. The Amended Complaint and Other Actionable Statements

In addition to its allegations regarding the press release, the amended complaint alleged that Ernst & Young had made a false statement in connection with BT's 1995 initial public offering prospectus. Specifically, in the amended complaint, Wright alleged that in a Report of Independent Auditors included in BT's prospectus, Ernst & Young certified the accuracy of BT's 1994 financial statements and BT's earnings for the first quarter of 1995, but "did not disclose that it only had performed a limited review of BT Summit." This report, the amended complaint alleged, was false and misleading. However, the district court concluded that the amended complaint failed to allege fully a § 10(b) cause of action on that ground because it failed to allege all the requirements for a Rule 10b-5 violation. Accordingly, the court sua sponte granted Wright leave to cure the defect. Wright, however, elected to file this appeal rather than replead.

On appeal, Wright argues that the amended complaint adequately states a cause of action for failure to correct the false financial information contained in that prospectus because by January 1996, Ernst & Young discovered facts tending to undermine the accuracy of those financial statements. Specifically, Wright argues in her brief that:

> Plaintiff alleged a misstatement -- the Report of Independent Auditors, signed by [Ernst & Young]; that the misstatement was material as evidenced by the fact that [BT's] financial results for 1994 eventually were restated; that the market relied on this misinformation as reflected in [BT's] stock price; and that defendant [Ernst & Young] was reckless, at least by January 1996, in not correcting this misstatement.

We disagree. In order to survive a motion to dismiss, a plaintiff bringing an action pursuant to § 10(b) and Rule 10b-5 must "plead that the defendant made a false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused plaintiff injury." San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 808 (2d Cir. 1996). Accounting firms "do have a duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying." Cornfeld, 619 F.2d at 927; see also SEC v. Manor Nursing Centers, 458 F.2d 1082, 1095 (2d Cir. 1972) ("Post-effective developments which materially alter the picture presented in the registration statement must be brought to the attention of public investors." (footnote omitted)); Lanza v. Drexel & Co., 479 F.2d 1277, 1304-05 (2d Cir. 1973) (scienter requires that a defendant act deliberately or recklessly). Silence where there is a duty to disclose can constitute a false or misleading statement within the meaning of § 10(b) and Rule 10b-5. See Basic, n.17.

In this case, however, although the amended complaint alleges that the prospectus contained false statements (i.e., the inaccurate 1994 results) in 1995, it does not allege the misrepresentation claim that Wright presses on appeal -- namely, that Ernst & Young made a false statement (by omission) in 1996 as a result of its duty and subsequent failure to correct those statements. In fact, an alleged duty to correct does not appear anywhere in the amended complaint and did not enter the case until Wright mentioned it for the first time in her opposition memoranda to the motion to dismiss. See Cornfeld, 619 F.2d at 914 & n.6 (a party is not entitled to amend its complaint through statements made in motion papers); see also Jacobson v. Peat, Marwick, Mitchell & Co., 445 F.Supp. 518, 526 (S.D.N.Y. 1977) (party may not amend pleading through statements in briefs). Furthermore, the amended complaint fails to allege that Ernst & Young knew or was reckless in not knowing in 1995 that the Report of Independent Auditors contained false financial information, that the market or those who purchased BT's stock during the 1996 class period relied on the 1995 report, or that the 1995 report caused damages. Accordingly, we find no basis for Wright's contention that the amended complaint states a § 10(b) cause of action.

Because Wright elected to stand on the amended complaint rather than replead by September 29, 1997, Ernst & Young argues that Wright has waived her opportunity to file a second amended complaint. We conclude that because the district court entered judgment in this action on September 30, 1997, Wright may not file a second amended complaint without first obtaining vacatur of that final judgment, which she has not done on this appeal.

CONCLUSION

Central Bank of Denver v. First Interstate Bank of Denver, (1994), and Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997), foreclose primary liability under the Act for false or misleading statements made by Ernst & Young because no false or misleading statement was attributed to Ernst & Young at the time of public dissemination. Accordingly, the district court did not err in dismissing the amended complaint on that ground. Further, we also agree with the district court that the amended complaint fails to state a cause of action under § 10(b) and Rule 10b-5 for failure to correct misstatements made in connection with the sale or purchase of securities. Accordingly, the judgment of the district court is affirmed.

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(Cite as: 1997 WL 563782 (S.D.N.Y.))

Irene L. WRIGHT, on behalf of herself and all others similarly situated,
Plaintiff,
v.
ERNST & YOUNG LLP, Defendant.

No. 97 CIV. 2189(SAS).

United States District Court, S.D. New York.

Sept. 10, 1997.

David A.P. Brower, Esq., Neil L. Zola, Esq., Wolf Haldenstein Adler Freeman & Herz LLP, New York, New York, Charles J. Piven, Esq., Law Offices of Charles J. Piven, Baltimore, Maryland, for Plaintiff.

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OPINION AND ORDER

SCHEINDLIN, D.J.

*1 Plaintiff filed an Amended Complaint on July 30, 1997, alleging claims for violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities Exchange Commission Rule 10b-5 promulgated thereunder ("Rule 10b-5"). Plaintiff claims that the defendant, a large accounting firm, recklessly failed to detect various acts of

financial malfeasance committed by employees of BT Office Products ("BT") while representing to the public that it had adequately audited the company's financial records. Plaintiff alleges that because of this recklessness, she bought BT stock at an artificially inflated price and suffered injury once BT's true financial picture emerged. Defendant moved to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. For the reasons that follow, defendant's motion is granted.

I. Legal Standard for Motion to Dismiss

In deciding a 12(b)(6) motion to dismiss, the court must accept as true material facts alleged in the complaint and draw all reasonable inferences in the nonmovant's favor. See . Such a motion cannot be granted simply because recovery appears remote or unlikely on the face of a complaint, because "[t]he issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." (quoting). Rather, dismissal can only be granted if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." (quoting).

In ruling on a motion to dismiss for failure to state a claim, the Court may take into consideration documents which are integral to the complaint and upon which it relies, such as the press release at issue in the instant case, without converting the motion into one for summary judgment. See ; .

II. Factual Background

For the purposes of deciding this motion, the following allegations are assumed to be true. BT Office Products ("BT") is a distributor of office products that embarked on a series of acquisitions in the late 1980's. One of the businesses

acquired was Summit Office Supply, Inc. ("Summit"), a stationer based in New York, which became a BT subsidiary. At some point during this period, BT engaged defendant Ernst & Young LLP ("E & Y") to audit BT's year-end financial statements. See Amended Complaint ("Cmplt.") ¶¶ 24-26.

E & Y issued audit opinions certifying the accuracy of BT's financial statements for the years ending December 31, 1993 and December 31, 1994. E & Y updated and re-released the latter opinion in July, 1995, for use in BT's initial public offering prospectus. The audit upon which E & Y based its 1994 opinion included a "full-scope" audit of several BT subsidiaries, but only a "limited review" of Summit's accounts. See id. at ¶¶ 31, 35, 41.

*2 In the fall of 1995, E & Y began a new BT audit that included a full- scope audit of Summit. Pursuant to this effort, it discovered an underaccrual of Summit's accounts payable, and alerted BT management to this fact. Upon further consideration, however, E & Y concluded that the underaccrual was not material, as it appeared to be largely a carryover of a similar underaccrual from the year before. See id. at ¶¶ 42-43.

On January 30, 1996, BT issued the press release that is the subject of this lawsuit. The release announced that BT had enjoyed impressive earnings and strong growth during 1995. See id. at ¶ 44. It also indicated, however, that the figures from which these conclusions were drawn were unaudited. E & Y was not mentioned in the release.

In late February and March of 1996, it became apparent to BT and E & Y that the underaccrual problem at Summit was more serious than had been previously believed. A further investigation revealed that not only had Summit employees used improper accounting techniques, but that a large

amount of company funds had been embezzled as well. In light of these discoveries, BT announced on March 28 that it was restating its 1995 financial results from a previously announced profit of $1.5 million to a loss of $200,000. The price of BT's stock fell precipitously, injuring plaintiff shareholders. See id. at ¶¶ 47-48. This suit followed.

III. Discussion

A. 10b-5 Claim

To recover under Rule 10b-5, a plaintiff must prove that the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff relied, to her detriment, on this representation or omission. See . A threshold question here is whether the plaintiff has satisfied the first part of this test; namely, whether E & Y's alleged actions rise to the level of an actionable representation or omission. Plaintiff advances two theories on this point.

First, plaintiff argues that E & Y can be held responsible for BT's January 30, 1996 press release because E & Y "signed off" on the accounting figures that formed the basis of the release. Because BT would not have released its financial results without E & Y's approval, according to plaintiff, the market understood the release as an implied assertion by E & Y that the statements were accurate. See Cmplt. ¶ 11.

The problem with this theory is that the press release explicitly stated that the financial statements were unaudited. It may be possible that some investors would infer an auditor's approval from a company's release of financial data. Such an inference, however, was simply not warranted in this case, as BT's data was accompanied by a clear and express warning that no audit had yet been completed: E & Y's only

"representation" as to the accuracy of those figures was that it made no representation at all. Under plaintiff's reasoning, E & Y's disclaimer would be transformed into a guarantee of the statements' accuracy. Such a result would not only be illogical, but would seriously deter disclosure of unaudited financial information as well.

*3 Plaintiff's second theory is that BT's financial statements were express (though indirect) representations by E & Y that BT had earned a profit of $1.5 million in 1995 and had operating income of $23.7 million. By "authorizing" BT to release these figures, plaintiff argues, E & Y effectively adopted them as its own. See Plaintiff's Memorandum of Law in Opposition to Defendant's Motion to Dismiss at 8. While BT's statements may have contained actionable misrepresentations, they were not made by, and cannot be attributed to, E & Y.

In , the Supreme Court held that aiding and abetting securities fraud was not prohibited by Rule 10b-5. Since that decision, there has been considerable disagreement among the lower courts as to when primary 10b-5 liability can be imposed upon defendants who have some connection with, but do not actually make, actionable misrepresentations. Compare (an accounting firm can be primarily liable under 10b-5 when it plays a "significant role" in drafting a statement containing misrepresentations released by its client) with (10b-5 liability can only attach when the defendant itself makes a misrepresentation).

Virtually all cases to have considered the issue, however, have required a greater degree of participation in the fraudulent conduct than the mere review and approval of unaudited figures. See, e.g., (accounting firm's review and approval of financial statements released by client cannot create 10b-5 liability); (allegations that accounting firm consulted, advised,

and guided client in making misrepresentations insufficient to state a 10b-5 claim); (allegations that underwriter participated in drafting and circulating a client's misleading prospectus insufficient). Holding E & Y primarily liable under Rule 10b-5 in spite of its clearly tangential role in the alleged fraud would effectivelv revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in Central Bank.

B. Leave to Amend

Rule 15(a) of the Federal Rules of Civil Procedure provides that the court should grant leave to amend "freely ... when justice so requires." The Second Circuit has noted that "[w]hen a motion to dismiss is granted, 'the usual practice is to grant leave to amend the complaint.' ... Although the decision whether to grant leave to amend is within the discretion of the district court, refusal to grant leave must be based on a valid ground." (quoting (quotations omitted)). Where the possibility exists that the defect can be cured, leave to amend at least once should normally be granted unless doing so would prejudice the defendant. See

*4 Plaintiff has not pled a viable 10b-5 claim against E & Y with respect to BT's January 30, 1996 press release. However, the Amended Complaint alleges that E & Y made misstatements on other occasions as well. See, e.g., Cmplt. ¶ 41 (alleging that E & Y certified the financial statements included in BT's prospectus). It is possible that such misstatements could rise to the level of 10b-5 violations, assuming the other required elements are properly pled. Because the defects in the Complaint could at least theoretically be cured, leave to amend is granted.

III. Conclusion

For the foregoing reasons, the Complaint fails to allege the essential elements of a Rule 10b-5 claim. Accordingly, defendant's motion to dismiss is granted with leave to amend. If plaintiff chooses to file an Amended Complaint, she must do so by September 29, 1997.

SO ORDERED:

Dated: New York, New York

September 9, 1997

U.S.C. TITLE 15 - COMMERCE AND TRADE
CHAPTER 2B - SECURITIES EXCHANGES

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2)

No. 98-783

Supreme Court, U.S.
FILED
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CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1998

IRENE L. WRIGHT, on behalf of herself and all others similarly situated,

Petitioner,

v.

ERNST & YOUNG LLP,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

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12 pp

QUESTION PRESENTED

Whether, under Section 10(b) of the Securities Exchange Act of 1934, persons who purchased stock in a company that issued a press release containing allegedly false and misleading information, with a notation that the information was unaudited and without mention of its outside auditor, can recover from the outside auditor based on its private approval of the information contained in the press release.

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In the Supreme Court of the United States

OCTOBER TERM, 1998

No. 98-783

IRENE L. WRIGHT, on behalf of herself
and all others similarly situated,

Petitioner,

v.

ERNST & YOUNG LLP,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

BRIEF FOR THE RESPONDENT IN OPPOSITION

Petitioner seeks review of a decision of the United States Court of Appeals for the Second Circuit affirming the dismissal of her complaint under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, against respondent Ernst & Young LLP ("Ernst & Young") in connection with her purchase of common stock of BT Office Products International ("BT" or "the Company"). The district court dismissed the action because petitioner sought to base liability not on any misstatement made by Ernst & Young, but rather on a BT press release announcing the Company's unaudited year-end financial results that did not mention Ernst & Young and that explicitly described the financial results as "unaudited." In the district court's view, petitioner's claim was an impermissible attempt to end-run this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), which held that there can be no liability

in private damage actions for aiding and abetting alleged violations of Section 10(b) and Rule 10b-5. The Second Circuit affirmed, holding that petitioner's claim is foreclosed by *Central Bank* and by its earlier decision in *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997), which adopted a "bright line" test requiring a material misstatement or omission by the defendant, as opposed to mere review and approval of another party's misstatement or omission, as a prerequisite to liability. The Second Circuit also concluded that petitioner's claim would be defective even under the "substantial participation" test adopted by the Ninth Circuit because there is no allegation that Ernst & Young participated in the creation of the BT press release.

In attempting to persuade this Court that the decision below is worthy of review, petitioner argues that there is serious circuit conflict and confusion on the scope of liability for Section 10(b) violations following *Central Bank*. As shown below, however, the particular question presented by the Petition — whether an auditor can be held liable for communicating false information to a company that it knows the company will disclose — is not even raised in this case, for there is no allegation that Ernst & Young's private advice to its client BT ever became public. Moreover, a ruling by this Court on the appropriate standard for liability would be premature, as that issue is now just beginning to percolate at the circuit level. Thus far, one circuit, the Tenth, has joined the court below in applying a "bright line" test that requires, as a prerequisite for liability, a material misstatement (or omission) that is made by the defendant and relied on by the plaintiff. Another circuit, the Ninth, has adopted an apparently more liberal "substantial participation" test that imposes liability on those who play a key role in creating a material misstatement that is in fact made by someone else. Petitioner fails to acknowledge, however, that even under the Ninth Circuit test, there could be no liability here because there is no allegation that Ernst & Young contributed to the

creation of BT's press release. Petitioner's inability to cite a single decision applying any legal standard that would sustain her allegations demonstrates the unworthiness of her complaint and this Petition.

STATEMENT

1. **The Complaint's Allegations.** On January 30, 1996, BT issued a press release announcing its unaudited 1995 financial results. The press release expressly described the Company's financial results as "unaudited" and made no mention of Ernst & Young, BT's independent outside auditor. Pet. 5a.

Three months later, on March 28, 1996, BT announced that it had discovered accounting and financial reporting irregularities, as well as inventory theft and embezzlement, at one of its subsidiaries and that, as a result, it was reducing its previously reported (unaudited) net income for the year. Pet. 5a. Approximately two weeks after that announcement, petitioner filed a class action lawsuit in the Southern District of New York, accusing the Company and a number of its officers of securities fraud. Pet. 3a-4a. In March 1997, those defendants agreed to pay $1,480,000 to the class in settlement of these claims. Pet. 4a.

On the last day before the statute of limitations would otherwise have expired, petitioner filed a second class action complaint against Ernst & Young. The only actionable misstatements alleged in the complaint were statements made by BT in its January 30 press release announcing the Company's unaudited 1995 financial results. Petitioner alleged that Ernst & Young was responsible for the press release because it was supposedly reckless in not discovering, before the release was made, that rogue employees of the Company had engaged in theft and fraud. Petitioner alleged that before BT issued the January 30 press release, Ernst & Young had provided "oral assurances" to the Company that its 1995 financial statements were accurate. She further

claimed that it was based on these assurances that BT made its earnings announcement. Although the complaint alleged that "the market" believed that the release of BT's 1995 financial results must have been approved by Ernst & Young because companies do not issue such press releases without their outside auditors' approval, the press release itself did not substantiate that allegation. Instead, it described BT's 1995 financial results as "unaudited." Pet. 3a-5a.

2. **The Decisions Below.** The district court granted Ernst & Young's motion to dismiss, holding that petitioner's allegations would be insufficient under any standard of primary liability adopted by the federal courts in the aftermath of *Central Bank*. Pet. 23a-25a. The court correctly observed (*see* n.3 *infra*) that "[v]irtually all cases . . . have required a greater degree of participation in the fraudulent conduct than the mere review and approval of unaudited figures." Pet. 24a. The court rejected petitioner's claim that Ernst & Young had "endorsed" the Company's January 30 announcement; given the press release's characterization of the Company's financial results as unaudited, "E&Y's only 'representation' as to the accuracy of those figures was that it made no representation at all." Pet. 23a-24a. The court concluded that sustaining the complaint in light of Ernst & Young's "clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank*." Pet. 25a.

The Second Circuit affirmed, relying on *Central Bank* and its own recent decision in *Shapiro*. In *Shapiro*, the court noted two differing standards in determining liability for Section 10(b) violations and elected to follow a "bright line" test under which the defendant cannot be held liable unless it actually made a material misstatement or omission on which the plaintiff relied. 123 F.3d at 720. Anything short of such conduct, the court concluded, was mere aiding and abetting,

which is insufficient to trigger liability under *Central Bank*. *Id*.

In the instant case, the Second Circuit held that the requisite standard was not satisfied because:

> BT's press release did not attribute any assurances to Ernst & Young and, in fact, did not mention Ernst & Young at all. Thus, Ernst & Young neither directly nor indirectly communicated misrepresentations to investors. Therefore, the amended complaint failed to allege that Ernst & Young made "a material misrepresentation (or omission) on which a purchaser or seller of securities relie[d]." *Central Bank*, 511 U.S. at 191.

Pet. 12a-13a.

Nor would the result likely be any different, the court reasoned, under the Ninth Circuit's "substantial participation" test. *See* Pet. 14a. Although declining to adopt that standard, the Second Circuit concluded that under it, "we would be hard pressed to conclude that the amended complaint alleged an actionable misrepresentation within the meaning of § 10(b)." Pet. 14a.

REASONS FOR DENYING THE WRIT

The Petition advances four principal reasons for review. First, petitioner argues that the Second Circuit standard is at odds with the Ninth Circuit's "substantial participation" test that was announced in a footnote in *In re Software Toolworks Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994). Second, petitioner asserts that the decision below conflicts with the Tenth Circuit's ruling in *Anixter v. Home-State Product Co.*, 77 F.3d 1215 (10th Cir. 1996), a leading decision addressing the scope of liability in the wake of *Central Bank*. Third, petitioner claims to have found yet a third test for primary liability in the Third Circuit's *vacated* decision in *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998), *vacated* [Current Transfer

Binder] ¶ 90,165 (3d Cir. Mar. 9, 1998). Finally, petitioner urges that review by this Court is necessary because of internal confusion within the Second Circuit on the appropriate liability standard.

As explained below, review should be denied because the question presented by petitioner is not even raised by the allegations in this case. Further, although the "substantial participation" test appears to differ from the "bright line" rule followed by the Second and Tenth Circuits, the Ninth Circuit standard has thus far gained no sizable following and, as the courts below recognized, would not save petitioner's claim in any event. These factors make this case a particularly poor vehicle for addressing the primary liability issue.

In addition, there is no conflict between the Tenth and Second Circuits. The *Anixter* standard is the same as the Second Circuit test – unsurprising given that the court below cited *Anixter* favorably in this case and in *Shapiro*. That leaves petitioner's contentions that this Court should exercise its discretionary jurisdiction because of an allegedly conflicting – but *vacated* – panel decision in *Klein* and because of supposed intra-circuit confusion. Neither ground would be good reason for granting review, and neither ground is meritorious even if it were certworthy.

Finally, the time is not yet ripe for this Court to address the precise scope of primary liability under Section 10(b) following *Central Bank*. That issue is only beginning to be considered in the courts of appeals. If this Court's intervention is ultimately needed, the Court will benefit from consideration of the issue in a number of different factual contexts by a number of different courts.

I. THE QUESTION PRESENTED BY PETITIONER IS NOT RAISED IN THIS CASE

Petitioner seeks this Court's review of the question:

> Can a secondary actor not identified in a public statement incur primary liability under Section 10(b) of the Securities Exchange Act of 1934 where he communicates false information to an issuer knowing that the issuer will publish that information?

Pet. i, 5. That question is irrelevant to this case because there is no allegation that BT published any information communicated to it by Ernst & Young.

Petitioner insists that Ernst & Young made material misrepresentations when it supposedly advised BT that the Company's unaudited 1995 financial results were sufficiently accurate to be disclosed and that the January 30 press release could be issued. Pet. 2, 14. But there is no allegation that this particular private advice ever made its way to the class, directly or indirectly. Rather, the only actionable misstatements alleged in the complaint were contained in *the Company's* press release, which did not even mention Ernst & Young:

> BT's press release did not attribute any assurances to Ernst & Young and, in fact, did not mention Ernst & Young at all. Thus, Ernst & Young neither directly nor indirectly communicated misrepresentations to investors.

Pet. 12a. As the court below aptly observed, "BT issued the press release without a whisper of Ernst & Young's involvement." Pet. 15a.[1]

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[1] Financial statements are, by definition, a representation by the company. That remains true even when the financial statements have been audited. The only statement by the independent outside auditor is the audit opinion itself. *See* 1 [CCH] AICPA,

Accordingly, if this Court were inclined to address the particular question presented by petitioner, it would have to do so on facts other than those alleged below. Petitioner's question, unlike petitioner's allegations, postulates a defendant communicating "false information to an issuer knowing that the issuer will publish *that information.*" Pet. (i), 5. (emphasis added). Because there is no allegation that Ernst & Young's private advice to its client was ever made public, the question presented by petitioner simply does not arise in this case.

II. EVEN UNDER THE NINTH CIRCUIT TEST, PETITIONER'S CLAIM WOULD FAIL

Petitioner correctly observes that "substantial participation" by a defendant in the creation of a material misstatement made by someone else is apparently sufficient in the Ninth Circuit to state a claim for primary liability. Pet. 8. *See In re Software Toolworks Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 966 (C.D. Cal. 1994).[2]

Professional Standards, Statements on Auditing Standards ("SAS") No. 1, AU § 110.02 ("The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements."). Thus, when a company discloses its year-end financial results *before* the auditor has issued any opinion, as BT did in this case, the only statement being made is a statement by the company.

[2] Some of the other authorities that petitioner cites to support liability under a "substantial participation" standard are curious in that they either do not follow that test or, alternatively, make it plain that petitioner's claim would not succeed under that standard. For example, petitioner cites *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997), as a case applying a "substantial assistance" test. Pet. 7.

What petitioner fails to address, however, is that even if a "substantial participation" test were applied here, the result would be the same. There is no allegation that Ernst & Young had any involvement in preparing BT's press release. Petitioner's only claim is that Ernst & Young gave oral assurances to the Company about the accuracy of the then-unaudited 1995 financial results and that those assurances prompted BT to issue the release. Pet. 14. No case decided after *Central Bank* has held that an accountant's private approval of a client's public communication is sufficient to state a claim for securities fraud. On the contrary, all of the authorities, pre- and post-*Central Bank*, reject any such claim.[3]

In fact, in this pre-*Shapiro* case, the court observed that the Second Circuit had not yet addressed what is necessary for the imposition of primary liability and did not decide which approach to follow because Kidder was potentially liable "[e]ven under the more stringent test." 933 F. Supp. at 315.

Further, although the court in *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425 (N.D. Ill. 1995) (cited at Pet. 7), framed its analysis in terms of Coopers's "substantial participation" in the alleged fraud, it nonetheless applied the Seventh Circuit rule antedating *Central Bank* that "primary liability under § 10(b) also requires an accountant's alleged misstatement to be certified, audited, prepared or reported." *Id.* at 432. There is no allegation in this case that could possibly meet that standard.

[3] *See, e.g., Latigo v. Laventhol & Howath*, 876 F.2d 1322, 1326-1327 (7th Cir. 1989) (accounting firm that performed quarterly reviews, but did not issue any audit opinion, could not be held responsible for the alleged misstatements in the company's reports of its interim financial results); *In re Cascade Int'l Sec. Litig.*, 894 F. Supp. 437, 443 (S.D. Fla. 1995) ("if an accountant does not issue a public opinion about a company, although it may have conducted internal audits or reviews for portions of a company, the accountant cannot subsequently be held responsible

The allegations of primary wrongdoing in the Ninth Circuit cases are far more substantial than what petitioner alleges here. For example, in *In re Software Toolworks*, the accountant, Deloitte & Touche, was not entitled to summary judgment on the Section 10(b) claim because it allegedly had played a key role in reviewing, drafting, and editing two letters to the SEC that were misleading. 50 F.3d at 628 n.3. A basis for primary liability existed, according to the Ninth Circuit, because:

> the July 1 SEC letter stated that it "was prepared after extensive review and discussions with . . . Deloitte" and actually referred the SEC to two Deloitte partners for further information. . . . Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter.

Id.

Here, in contrast, the most that petitioner could muster is an allegation that BT prepared its own misleading press release based on erroneous advice from Ernst & Young – a prototypical aiding and abetting claim[4] now proscribed under

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for the company's public statements issued later..."); *In re Gas Reclamation, Inc. Sec. Litig.*, 659 F. Supp. 493, 505 (S.D.N.Y. 1987) (accounting firm could not be held liable for alleged misstatements in company's disclosures "where it has not given some representation or certification, such as an opinion or certified statement, or has not invited the public to rely on the firm's financial judgment at the time"); *Cashman*, 877 F. Supp. at 432 ("[p]rimary liability under §10(b) also requires an accountant's alleged misstatement to be certified, audited, prepared or reported").

[4] A leading securities commentator has characterized the very allegations made in petitioner's complaint as asserting an aiding and abetting claim: "The accountant would be liable as an aider and abettor if it prepares false unaudited figures *or suggests that the*

Central Bank, which requires proof of "all" of the elements of a Section 10(b) violation, including "a material misstatement (or omission) on which a purchaser or seller of securities relies . . . ." *Central Bank*, 511 U.S. at 191. Thus, as recognized below, petitioner's allegations against Ernst & Young fell short whether analyzed under the Ninth Circuit "substantial participation" standard or under the Second Circuit "bright line" rule. *See* Pet. 14a, 24-25a.[5]

There may be significant differences in some cases between the "bright line" rule adopted by the Second and Tenth Circuits and the "substantial participation" test suggested by the Ninth Circuit in determining the scope of primary liability under Section 10(b). The lower courts continue to debate which of the standards is more faithful to the statute and to this Court's decision in *Central Bank*. That issue may someday require resolution by this Court. A choice among competing standards would make no sense in this case, however, where petitioner's allegations are so deficient that dismissal is required regardless of which standard is applied.

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company release misleading statements." 5C Arnold S. Jacobs, *Litigation And Practice Under Rule 10b-5*, § 66.01(d), at 3-504 (1977) (emphasis added).

[5] *See also Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (allegations that an accounting firm consulted, advised, and guided client in making misrepresentations insufficient to state a claim for securities fraud); *Wells v. Monarch Capital Corp.*, [1996-1997 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 99,344, at 96,091 (D. Mass. Oct. 22, 1996), *aff'd*, 129 F.3d 1253, (1st Cir. 1997) (allegations that misleading documents that were "prepared under the direction of" an accountant who was "responsible for their accuracy and completeness" were "claims for aiding and abetting under either approach, and are barred by the *Central Bank* decision") (internal quotation marked omitted).

III. *ANIXTER* AND THE DECISION BELOW APPLY THE SAME TEST

Ever in search of a conflict, petitioner argues that the decision below is incompatible with the Tenth Circuit's ruling in *Anixter*. Pet. 4. Specifically, petitioner insists that *Anixter* properly recognizes that a defendant can be liable for making an "indirect" material misstatement to investors, while the Second Circuit supposedly rejected that principle. Pet. 4, 7.

Petitioner is forced to concede, however (*see* Pet. 9-10), that this argument does not survive a fair reading of the Second Circuit's opinion. The court below explicitly recognized that "'[t]here is no requirement that the alleged violator directly communicate misrepresentations to [investors] for primary liability to attach.'" Pet. 12a (quoting *Anixter*, 77 F.3d at 1226).

Petitioner nonetheless persists in urging that the Second Circuit has "effectively" eliminated liability for "indirect" misrepresentations by requiring that any alleged misstatement be attributed to the defendant. Pet. 4, 10. *Anixter*, however, enforced the same requirement in holding, like the court below, that an alleged material misstatement must have been made by the defendant, and not someone else, in order for liability to attach.

In *Anixter*, the court cautioned that "for an accountant's misrepresentation to be actionable as a primary violation, there must be a showing that he knew or should have known that *his representation* would be communicated to investors because § 10(b) and Rule 10b-5 focus on fraud made 'in connection with the sale or purchase' of a security." 77 F.3d at 1226 (emphasis added). The Tenth Circuit explained that this requirement is essential after *Central Bank* and expressly rejected the view that the "'substantial assistance' element of aiding and abetting liability" can be "reformulate[d]" by the simple expedient of making an accountant liable for a client's

statement. 77 F.3d at 1226 n.10. In the Tenth Circuit's view:

> The critical element separating primary from aiding and abetting violations is the existence of a representation either by statement or omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability. *See Central Bank of Denver*, 511 U.S. at 176-178, 114 S. Ct. at 1448.

Anixter, 77 F.3d at 1225. This is the very same "bright line" rule adopted by the Second Circuit in *Shapiro* and applied by the court below. *See* Pet. 11a.

Significantly, in applying that standard, the Tenth Circuit differentiated between primary and secondary claims in the same way that the Second Circuit distinguished between them in this case. The accountant in *Anixter*, Cross, had issued audit opinions on the financial statements of his client, Home-Stake, and had also assisted Home-Stake in preparing limited partnership offering materials. The court concluded that Cross *could* be held liable for *his* own public statements in the form of opinions – which, of course, were publicly attributed to him – but could *not* be held liable for his *client's* statements even though he may have contributed substantially to creating them. The court reversed a forty million dollar judgment in a twenty-year-old case because it was unclear from the verdict whether the jury had found Cross liable because of his role in Home-Stake's misrepresentations "or whether his liability rested on actual representations he made that reached investors." *Id.* at 1230-1231.

The court below likewise concluded that one cannot transform secondary liability claims prohibited by *Central Bank* into legitimate primary claims by the simple expedient of tagging the secondary actor, in this case the accountant, with the client's statement. Accordingly, there is no substance to this supposed conflict – or to petitioner's dark

prediction that the Second Circuit has "effectively eliminated liability for any indirect misstatements by a party no matter the degree of culpability of that party in perpetrating a fraud on the public." Pet. 10.

IV. THE VACATED *KLEIN* DECISION OFFERS NO REASON TO REVIEW THIS CASE

The Petition relies heavily on the panel decision in *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998), *vacated* [Current Transfer Binder] ¶ 90,165 (3d Cir. Mar. 9, 1998), arguing that *Klein* is "remarkably similar" to this case (Pet. 5), and that the Third Circuit adopted a liability standard that differs from both the Second and Ninth Circuit tests. *See* Pet. 12-15. Even if this characterization of the decision were accurate, the fact that *Klein* was vacated wipes out any conflict. A recent Third Circuit order dismissing the *Klein* appeal also ensures that the panel decision will not be reinstated on en banc review. *Klein v. Boyd*, Nos. 97-1143 and 97-1261, Order dated Nov. 12, 1998.

In any case, petitioner's characterization of *Klein* is inaccurate. The liability standard adopted by the panel decision is essentially the same as the Ninth Circuit test, as it would have imposed liability "when the person's participation in the creation of a statement containing a misrepresentation or omission of material fact is sufficiently significant that the statement can properly be attributed to that person as its author or co-author." *Klein*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,325.

Equally important, the factual allegations in *Klein* differ markedly from the allegations here. The lawyer-defendants in *Klein* were the primary authors of the allegedly misleading partnership disclosure packages (*id.* at 90,320). In this case, by contrast, there is no allegation that Ernst & Young contributed at all to drafting the BT press release. Thus, even if *Klein* were valid precedent (which it is not), there is

no reason to believe that petitioner would enjoy any more success under the *Klein* standard than under the Second Circuit test.

V. ALLEGED SECOND CIRCUIT CONFUSION SHOULD NOT PROMPT THIS COURT'S REVIEW

Petitioner argues that the Second Circuit has issued inconsistent decisions on the scope of liability under Section 10(b), "indicating that the time is ripe for this Court to clarify its decision in *Central Bank*." Pet. 8. It is well established, however, that conflicting decisions within a circuit raise a problem to be resolved by that circuit rather than by review in this Court. *See, e.g., Wisniewski v. United States*, 353 U.S. 901, 902 (1957).

Further, as the court below recognized (Pet. 13a-14a), there is no conflict between the decision below or *Shapiro* and the court's prior decision in *SEC v. First Jersey Securities Inc.*, 101 F.3d 1450 (2d Cir. 1996). In *First Jersey Securities*, a fraud action brought by the SEC, the Second Circuit held that where the sole owner, officer, and director of a company – Brennan – directed the employees of his company – First Jersey – to make false and misleading statements to customers as part of an elaborate scheme to defraud, Brennan was primarily liable for the actions of his employees, and responsible also as a "controlling person" under the Securities Exchange Act. 101 F.3d at 1471-1474. *First Jersey Securities* thus stands for the proposition that the owner and chief executive officer of a business cannot escape responsibility for securities frauds committed by his employees when the fraud "could only have occurred at the direction of upper level management," and when the defendant "was engaged in the purposeful planning" of the fraud. 103 F.3d at 1471-1472.

Similarly, petitioner's contention (Pet. 9), that the Second Circuit recently retreated from its "bright line" rule in *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107 (2d Cir. 1998),

reflects a misreading of that case. The court acknowledged that Section 10(b) prohibits market manipulation *(id.* at 108), and that a defendant who effects "the very buy and sell orders that manipulated [the company's] stock upward" is primarily liable for the violation. 155 F.3d at 112. As the court observed, "if the trader who executes manipulative buy and sell orders is not a primary violator, it is difficult to imagine who would remain liable after *Central Bank.*" *Id.*

Finally, we disagree that the time is ripe for this Court to clarify the scope of liability in the wake of *Central Bank.* Only three federal circuits have addressed the issue, which is in a state of flux and would undoubtedly benefit from further consideration by the lower courts.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1998

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No. 98-783

In The

Supreme Court of the United States

October Term, 1998

IRENE L. WRIGHT, on behalf of herself and all others similarly situated,

Petitioner,

-v-

ERNST & YOUNG LLP,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S SUPPLEMENTAL BRIEF TO PETITION FOR A WRIT OF CERTIORARI

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PETITIONER'S SUPPLEMENTAL BRIEF TO PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 15.8 of the Rules of the Supreme Court of the United States, petitioner Irene L. Wright hereby submits this Supplemental Brief to her Petition for a Writ of Certiorari (the "Petition"). The Petition was filed with the Court on November 4, 1998, and placed on this Court's docket on November 13, 1998.

Petitioner is seeking review of the Second Circuit's decision in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), which held, *inter alia*, that a secondary actor cannot be liable under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") for making a false or misleading statement unless that actor is identified as the source of the misstatement. Petitioner contends that the Second Circuit's holding is based on a misinterpretation of this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). She explains in her Petition that because several Circuit Courts of Appeal interpreting *Central Bank* have reached widely varying conclusions on the question of the liability of secondary actors under Section 10(b) of the Exchange Act, this Court should clarify *Central Bank*. As petitioner points out, the Third Circuit, in *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998), *vacated*, *Klein v. Boyd* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,165 (3d Cir., Mar. 9, 1998), reached the exact opposite conclusion as did the Second Circuit in *Wright*, holding that direct attribution was not necessary for liability to

attach under Section 10(b). This Supplemental Brief discusses a recent case in the Eleventh Circuit that agrees with the *Klein* holding.

On November 16, 1998, approximately two weeks after the filing of Ms. Wright's Petition, a federal district court in the Eleventh Circuit agreed with *Klein* that a secondary actor does not have to be identified as the source of a misstatement to be held liable under the Exchange Act for that misstatement. The court explicitly rejected the Second Circuit's holding that attribution is necessary for liability under the Exchange Act and held that the appropriate test to determine whether primary liability attaches to a secondary actor is whether that secondary actor "creates a misrepresentation." *Carley Capital Group v. Deloitte & Touche, L.L.P.*, No. 1:97-CV-3183-TWT, slip op., Appendix at 18a (N.D. Ga. Nov. 16, 1998).

In *Carley Capital*, defendant Deloitte & Touche ("Deloitte"), a large international accounting firm, was accused of directing, reviewing, and approving several false and misleading statements with respect to its client's financial statements. Deloitte had no direct contact with the market. These statements were allegedly knowingly prepared in violation of Generally Accepted Accounting Practices (GAAP). Deloitte moved to dismiss on the grounds that the allegedly false financial results were unaudited and that Deloitte had not made any public statements. Therefore, Deloitte argued, plaintiff's allegations with respect to certain of these alleged misstatements constituted nothing more than claims for aiding and abetting liability, for which it could not be held

liable under *Central Bank*. The *Carley Capital* court recognized that the Circuits interpreting *Central Bank* had rendered inconsistent decisions: "Since the decision in *Central Bank*, the federal courts have split over the threshold required to show that a secondary actor's conduct constitutes primary liability. The Eleventh Circuit has yet to consider this issue." *Carley Capital*, Appendix at 17a.

In ruling on this issue, the *Carley Capital* court noted that the approach taken by the Second Circuit – which requires that an actionable misstatement actually be attributed to the author at the time of the misstatement's dissemination – created a loophole through which sophisticated defrauders could escape liability simply by concealing their identity from the public. Thus, rather than place the emphasis on the market's knowledge of the identity of the secondary actor, the *Carley Capital* court adopted a test which looks to the defendant's conduct, *i.e.*, whether a secondary actor had a role in creating the misrepresentation at issue. This standard was proposed by the Securities and Exchange Commission ("SEC") in an *amicus curiae* brief submitted in *Klein* (attached hereto, Appendix at 38a) and relied upon by the *Carley Capital* court:

> This Court adopts the standard urged by the SEC and concludes that a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation *even if the misrepresentation is not publicly attributed to it. Under the Second Circuit standard, a secondary actor who is the actual creator and author of a material misstatement could avoid liability simply due to the concealment of its identity.* The Court finds that there is nothing in *Central Bank* with

> regard to its use of the terms "makes" or "making a material misstatement" that limits liability to those individuals who sign documents or are otherwise identified to investors. The standard adopted by the Court is consistent with the "directly or indirectly" language in Section 10(b).

Appendix at 18a-19a (emphasis added).

The *Carley Capital* court then held that where plaintiff alleged that Deloitte had directed the inclusion of false income in a financial report, even though the statement of the income was not attributed to the defendant (and where the defendant was not even identified), Deloitte could be held liable as a primary violator of Section 10(b) because it had "created" the misrepresentation. Appendix at 19a. In issuing its ruling, the *Carley Capital* court agreed with *Klein*, stating that the identification of the party making the statement to the market was not a prerequisite to liability. *Id.*

Thus, yet another jurisdiction has adopted a standard at odds with the approach of the Second Circuit as discussed in the Petition. The *Carley Capital* case, in supporting *Klein*, as well as the SEC's *amicus curiae* brief submitted in *Klein*, presents strong further support for petitioner's argument that the Court should resolve the

discrepancies among the Circuits and take the opportunity in this case to clarify its holding in *Central Bank*.

Respectfully submitted,

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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

CARLEY CAPITAL GROUP, et al.,	)	
Plaintiffs,	)	
v.	)	CIVIL ACTION FILE NO. 1:97-CV-3183-TWT
DELOITTE & TOUCHE, L.L.P.,	)	
Defendant.	)	

ORDER

(Filed Nov. 16, 1998)

This is a complex securities litigation case. It is before the Court on the (1) Defendant's Motion to Dismiss the Amended Complaint [Doc. No. 40]; (2) Defendant's Motion for Judgment an the Pleadings or to Dismiss [Doc. No. 41]; and (3) Plaintiffs' Motions for Leave to File Sur-Reply Memoranda [Doc. Nos. 55 and 56]. This matter came on for hearing on October 5, 1998. As a preliminary matter, this Court grants the Plaintiffs' Motions to File Sur-reply Memoranda [Doc. Nos. 55 and 56]. For the reasons set forth below, the Court will deny the Motion to Dismiss and deny the Motion for Judgment on the Pleadings.

I. BACKGROUND

The Plaintiffs filed this consolidated shareholder action asserting various securities-fraud claims against

Defendant Deloitte & Touche, LLP. The facts in this case are related to claims arising in the action entitled *In re 1996 Medaphis Corporation Securities Litigation*, Civil Action No. 1:96-CV-2088-TWT (N.D.Ga. 1996) ("*Medaphis* action"). The *Medaphis* action was settled for $72.5 million in cash and securities. This action is based, at least in part, on the discovery undertaken in the *Medaphis* action. The Plaintiffs bring this action on behalf of members of a potential class ("Class Plaintiffs") who purchased the common stock of Medaphis Corporation ("Medaphis") during the class period between February 6, 1996, through October 21, 1996. Certain Plaintiffs assert separate claims on behalf of members of a potential sub-class ("Sub-class Plaintiffs") who, in connection with a merger between Medaphis and Health Data Sciences Corp. ("HDS"), exchanged their shares of HDS stock for shares of Medaphis common stock between June 29, 1996, and October 21, 1996.

Medaphis sells outsourced business management services to doctors and hospitals, primarily for the management of billing and accounts receivable.[1] Medaphis also provided, during the relevant time period, systems integration and flow engineering services. For several years before the Class Period, a principal component of Medaphis' business strategy involved growth through

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[1] The factual allegations of the Amended Complaint are deemed true with respect to the pending motions. *Bank v. Pitt*, 928 F.2d 1108, 1109 (11th Cir. 1991). The issues raised in the Motion to Dismiss and the Motion for Judgment on the Pleadings may be revisited if the factual allegations of the Amended Complaint are tested by a motion for summary judgment.

acquisitions of other companies in the medical billing business. This acquisition strategy enabled Medaphis to report impressive growth of revenues from $86 million in 1991, to over $300 million In 1994. By 1994, Medaphis had grown from an obscure business into the dominant player In its field.

During the second half of 1994, however, the revenue and profit margins of the billing and accounts receivable management business declined. As a result, Medaphis began searching for new technologies to cut its internal costs of collecting and sending out bills. Medaphis also decided to focus on computer systems integration companies as acquisition targets. In December, 1994, Medaphis acquired the assets of a systems integration business, Gateway Conversion Technologies ("Gateway"), including scanning and optical character recognition software ("Imonics software"). This was Medaphis' entry into the systems integration business. After the acquisition, this aspect of Medaphis' business was conducted by its Imonics Corporation ("Imonics") subsidiary.

In July, 1995, representatives of Imonics met with representatives of two subsidiaries of Bertelsmann AG ("Bertelsmann"), a German corporation, regarding a possible joint venture arrangement to provide custom systems integration services to European customers. By the end of 1995, Imonics and the Bertelsmann subsidiaries identified DeTe Mobil, a large German company, as a potential client for customized software and reengineering solutions. On December 21, 1995, the last business day before the Christmas holidays and the end of the 1995 fourth quarter, Imonics and the Bertelsmann subsidiaries entered into two related agreements in connection

with the purported joint venture to provide custom systems integration work in Europe.

In the first agreement, the parties executed a "Software Licensing Agreement," by which one of the Bertelsmann subsidiaries obtained a non-exclusive license to sub-license Imonics Software to customers throughout Europe. That agreement provided that the Bertelsmann subsidiary would pay Imonics a license fee of five million Deutschmarks (approximately $3.5 million) upon delivery of the software. Under the Software Licensing Agreement, payment was not due until February 1, 1996. On the same day that the Software Licensing Agreement was executed, representatives of Imonics and another Bertelsmann subsidiary executed a letter agreement confirming the mutual Intentions of entering into a "definitive joint agreement" on or before January 31, 1996. If the closing of the joint venture did not occur in a timely fashion, Imonics would be required to pay liquidated damages in the amount of $3.6 million. Any obligations of an affiliate Bertelsmann subsidiary under the Software Licensing Agreement could be used to offset the liquidated damages amount. The joint venture between the parties was not formed until after January 31, 1996.

On March 29, 1996, the Imonics-Bertelsmann Joint Venture entered into a "Software Licensing and Software Engineering Contract" with DeTe Mobil (the "DeTe Mobil Contract"). The DeTe Mobil Contract provided that Imonics and Bertelsmann would provide systerns integration services to create, in effect, a paperless office for DeTe Mobil. The project would incorporate certain existing Imonics software. The DeTe Mobil Contract provided that DeTe Mobil would be entitled to liquidated damages

in the event that DeTe Mobil determined that the joint venture's performance was insufficient. On the day that the agreement was executed, the last day of the first quarter of 1996, Medaphis recorded $12.5 million in revenues. This represented its 50% share of anticipated earnings from software licensing fees due under the DeTe Mobil Contract.

The Defendant, a large international accounting firm, was the auditor and business consultant for Medaphis at all relevant times. The Defendant had an extensive in-house presence at Medaphis. The Defendant involved itself in the management of Medaphis by serving as a management consultant. The Defendant's representatives (1) occupied and continually staffed offices at Medaphis for duties performed in connection with Medaphis' business; (2) had unlimited access to all of Medaphis' records and documents, (3) attended meetings of Medaphis' Board of Directors and the Audit Committee of the Board; and (4) reviewed all license agreements concerning software owned by Medaphis. Before and during the class periods, the Defendant directed Medaphis' accounting and performed extensive analyses of Medaphis' systems integration efforts. For example, the Defendant examined the DeTe Mobil Contract in connection with its review of Medaphis' first quarter 1996 financial statements. Due to the Defendant's extensive audit and consulting activities, Medaphis was one of the largest clients of the Defendant's Atlanta office. The Defendant received almost $200,000 for evaluation of Medaphis' systems integration project alone. The Defendant also received large fees from Medaphis for services in connection with Medaphis'

acquisitions, acquisitions which were dependent on Medaphis' continued earnings growth.

This securities fraud case is based primarily upon the Defendant's alleged false representations in connection with the reporting of Medaphis' financial results for 1995 and 1996. In the seven quarters before the Class Periods, Medaphis reported sequential increases in income before incurring what Medaphis describes as non-recurring charges. In the September 30, 1995, Form 10-Q, Medaphis disclosed that revenues from its billing and accounts receivable management services had declined. However, this quarterly report stated that the decline had been offset through expanded growth in its information management and systems integration services operations. The September 30, 1995, 10-Q report disclosed a net income of approximately $10.4 million before the non-recurring charges. By the fourth quarter of 1995, profits from billing and accounts receivable management services had virtually evaporated. However, on February 6, 1996, Medaphis issued a press release announcing its 1995 fourth quarter earnings of $11.4 million before the non-recurring charges. This represented a 50% increase in earnings over earnings during the fourth quarter of 1994.

On or about April 1, 1996, Medaphis filed its 1995 Form 10-K with the Securities and Exchange Commission ("SEC"), and disseminated its 1995 Annual Report to its shareholders and other members of the investing public. Medaphis' 1995 financial Statements appeared in the 1995 Annual Report and were incorporated by reference in the 1995 Form 10-K. The financial statements stated that they were prepared on the basis of Generally Accepted Accounting Principles. The 1995 Form 10-K included the

financial results for the 1995 fiscal year and fourth quarter as reported in the February 6, 1996, press release. The 1995 Annual Report Included the Defendant's March 15, 1996, audit opinion on Medaphis' 1995 financial statements. The audit opinion was incorporated by reference in the 1995 Form 10-K. The audit opinion stated that the financial statements were prepared in conformity with Generally Accepted Accounting Principles and that the financial statements presented fairly, in all material respects, the financial position of the company. A footnote to the financial statements expressly stated that revenues from systems integration contracts were recorded on the percentage of completion method of accounting.

In its audit opinion, the Defendant represented that its audit was conducted in accordance with Generally Accepted Auditing Standards. The Plaintiffs assert that this material representation was knowingly and recklessly false as the Defendant failed in a variety of ways to conduct its audit of Medaphis' 1995 financial statements in accordance with Generally Accepted Auditing Standards. (*See* Amended Complaint at ¶¶ 92-103). For example, the Plaintiffs allege with respect to the Software Licensing Agreement that the Defendant, in violation of Generally Accepted Auditing Standards, failed to obtain direct confirmation from the Bertelsmann subsidiary that the subsidiary actually owed Medaphis $3.5 million on December 31, 1995. (*Id.* at 98, 101). In addition, Plaintiffs allege that the Software Licensing Agreement showed on its face that it was not to be performed in 1995. Therefore, no revenues from the contract should have been recognized in 1995. (*Id.* at 38). The Defendant further represented that the financial statements fairly indicated

Medaphis and its subsidiaries' financial condition at the end of 1995 in accordance with Generally Accepted Accounting Principles. The Plaintiffs assert that this material representation was knowingly and recklessly false. Among other things, they allege that the Defendant advised Medaphis during the course of the 1995 audit that Medaphis had understated expenses by $4 million. They further allege in connection with the 1995 audit, that the Defendant had communicated to Medaphis' Audit Committee the overstatement of income relating to several systems integration contracts. Plaintiffs allege that the 1995 audited financial reports overstated Medaphis' income by approximately $9 million. Nevertheless, the Defendant issued an unqualified opinion with respect to 1995 financial records incorporating the understated expense figures and overstated revenue figures.

The Plaintiffs also allege that the Defendant participated in the February 6, 1996, press release which contained materially false and misleading statements. They allege that the Defendant had informed Medaphis before the issuance of the press release that the results comported with Generally Accepted Accounting Principles and that the Defendant had reviewed and approved the press release before issuance. Nevertheless, according to the Amended Complaint, the February 6, 1996, press release reported, in violation of Generally Accepted Accounting Principles, approximately $3.5 million in purported revenue and income from the Software Licensing Agreement which was neither paid nor owed to Medaphis in 1995. Plaintiffs also allege that the press

statement contained false reports of 1995 expenses and income.

On April 23, 1996, Medaphis issued a press release to announce its 1996 first quarter results. Medaphis included $12.5 million in revenues and income recognized in connection with the DeTe Mobil Contract in the 1996 first quarter figures even though the contract could not have been performed in that quarter. These revenues represented almost all of the $13.2 million in earnings that Medaphis was able to report for the first quarter of 1996. On May 14, 1996, Medaphis filed with the SEC its 10-Q quarterly report which echoed the financial results reported in the April 23, 1996, press release. The Plaintiffs assert that the statements concerning the 1996 first quarter financial results were materially false and misleading because such results included revenues and income from the DeTe Mobil contract in violation of Generally Accepted Accounting Principles and Medaphis' own stated revenue recognition policy. The Plaintiffs allege that the Defendant participated in the making of these statements by (1) reviewing and approving the April 23, 1996, press release before it was issued; and (2) specifically directing the inclusion of $12.5 million of revenues and income from the DeTe Mobil Contract in the financial results reported.

Because of the materially false and misleading statements described above, the Plaintiffs allege that Medaphis was able to continue its practice of acquiring companies with artificially inflated Medaphis Stock. In addition to acquiring Rapid Systems Solution and BSG Corporation, Medaphis announced, around May 24, 1996, its intention to acquire HDS in exchange for 6,125,000

Medaphis common shares and assumption or issuance by Medaphis of stock options representing an additional 556,000 shares. The merger was valued at approximately $273.5 million based on the closing price of Medaphis stock on May 24, 1996, at $40.938 per share. HDS was a developer and supplier of health care information systems to institutions, payers, health care networks, and providers. The merger agreement provided that HDS could unilaterally terminate the deal if the average closing price of Medaphis stock dropped below $37 per share.

On May 31, 1996, in connection with the HDS merger, Medaphis filed a registration statement with the SEC ("HDS Registration Statement"), which included a Proxy Statement/Prospectus ("Prospectus"). The HDS Registration Statement and Prospectus explicitly incorporated by reference the 1995 Form 10-K and the 1996 Form 10-Q for the first quarter of 1996. The Plaintiffs allege that the Defendant consented to the incorporation by reference of the March 15, 1996, audit opinion in the HDS Prospectus, knowing that it would be relied upon by HDS shareholders in determining whether to exchange their HDS shares for shares of Medaphis stock. The Plaintiffs allege that (1) HDS never would have completed the merger if the full truth about Medaphis' financial condition had been disclosed, and (2) the Defendant's fraudulent conduct enabled Medaphis to purchase HDS with overvalued stock, thereby costing HDS shareholders hundreds of millions of dollars in losses.

In mid-1996, DeTe Mobil became dissatisfied with Medaphis' performance of the systems integration agreement and decided to terminate the agreement. This made it impossible for Medaphis to earn the income it had

already reported for the first quarter of 1996. On August 14, 1996, Medaphis announced that it would lose $0.28 to $0.33 per share in the 1996 third quarter. The Plaintiffs allege that Medaphis stock price plunged downward $21.375 per share to close at $14.25 per share on August 15, 1996. The August 14, 1996, press release reported that a substantial portion of its difficulties arose from the need to reorganize the Imonics subsidiary and problems with the DeTe Mobil Contract. According to the press release, approximately $9 million of charges would be made during the 1996 third quarter to account for the "restructuring" of the DeTe Mobil Contract with another $15 million relating to the Imonics reorganization.

On October 22, 1996, Medaphis disclosed its actual financial results for the third quarter and announced that the previously reported revenues and earnings for the fourth quarter and full year of 1995 were false and had to be restated. The October 22, 1996, press release explained that the restatements in earnings for these time periods resulted principally from improperly recorded revenues in the Imonics division. In the press release, Medaphis admitted that the Imonics unit had improperly booked revenue on the Software Licensing Agreement. Medaphis reported a loss of $36.4 million for the 1996 third quarter. Further, Medaphis disclosed total charges of approximately $50 million in the third quarter relating primarily to the reorganization of Imonics and the write-off of revenue from the DeTe Mobil contract. As a result of these disclosures, Medaphis' stock dropped to $10.375 per share.

Based on these allegations, the Class Plaintiffs assert that the Defendant knowingly and recklessly violated

Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated by the SEC pursuant to Section 10(b). They allege that during the class periods, the Defendant made the false and misleading statements discussed above concerning the financial condition of Medaphis while having either actual knowledge of the false representation or acting with reckless disregard for the truth even though the facts were available to it. As a result of these false statements, the Plaintiffs assert that the market price of Medaphis common stock was inflated and that Plaintiffs purchased their shares at these inflated prices in reliance either on the integrity of the market or directly on the statements and reports of the Defendant.

The Sub-Class Plaintiffs further assert that the individual Defendant is liable under Section 11 of the Securities Exchange Act. 15 U.S.C. § 77k. They assert that the Defendant caused and participated in the issuance of materially false and misleading statements to the public which were contained in the HDS Registration Statement and Prospectus. As a result, the Plaintiffs assert that they acquired shares of Medaphis stock pursuant to, or traceable to, the HDS Registration statement. They assert that they have been damaged due to the subsequent drop in the value of Medaphis stock.

The Defendant has moved to dismiss the case in its entirety under Fed.R.Civ.P. 12(b)(6) for failure to state a claim [Doc. No. 40]. The Defendant contends that the Plaintiffs' allegations as to Medaphis' unaudited 1996 first quarter earnings report and the various related press statements and financial statements do not state a Rule 10b-5 claim for primary liability. With regard to the allegations concerning both the audited 1995 earnings report

and the 1996 first quarter earnings report, the Defendant contends that the Amended Complaint fails to comply with Fed.R.Civ.P. 9(b) and the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 ("Reform Act"), Pub.L. No. 104-67, 109 Stat. 743 (codified at 15 U.S.C. § 78u-4(b)). The Defendant contends that the Section 11 claim should be dismissed for failure to plead the allegations with the particularity required by Rule 9(b). The Defendant also contends that no Section 11 claim arises from Medaphis' unaudited 1996 first quarter financial results because it issued no statement concerning the results.

The Plaintiffs respond by arguing that the Amended Complaint properly identifies the Defendant's fraud with particularity and satisfies the heightened-pleading standards of Rule 9(b) and the Reform Act. They contend that the Defendant may be primarily liable for participation in statements that are issued by others. They contend that the Defendant's misrepresentations in the audit report were material. The Plaintiffs further contend that they have sufficiently pled their Section 11 claim regarding the Defendant's false statements incorporated in the HDS Prospectus.

Pursuant to Fed.R.Civ.P. 12(c) and Rule 12(b)(6), the Defendant has filed a separate Motion for Judgment on the Pleadings or to Dismiss [Doc. No. 41]. The Defendant contends that the Plaintiffs were placed on notice of their asserted claims for relief more than one year before filing their original Complaint on October 21, 1997, and that the action is therefore time-barred by the one year statute of limitations in Section 9(e) of the Securities Exchange Act. The Plaintiffs respond that there is no basis for finding as

a matter of law that the Plaintiffs discovered or should have discovered facts constituting the Defendant's alleged securities law violations before October 22, 1996.

II. STANDARDS FOR A MOTION TO DISMISS

Generally, a complaint should be dismissed under Rule 12(b)(6) only where it appears beyond doubt that no set of facts could support the plaintiff's claims for relief Fed.R.Civ.P. 12(b)(6); *see Conley v. Gibson*, 355 U.S. 41, 47, 78 S.Ct. 99. 102, 2 L.Ed.2d 80 (1957); *Linder v. Portocarrero*, 963 F.2d 332 (11th Cir. 1992); *In re Valujet, Inc. Sec. Litig.*, 984 F.Supp. 1472, 1476 (N.D. Ga. 1997). The Court must accept as true the facts pleaded in the complaint and construe them in the light most favorable to the plaintiff. *See Quality Foods de Centro America, S.A. v. Latin American Agribusiness Dev. Corp., S.A.*, 711 F.2d 999, 994-95 (11th Cir. 1983). Exhibits and affidavits attached to the complaint may also be considered as part of the complaint. *See Fed.R.Civ.P. 10(c); Breckenridge Creste Apartments v. Citicorp*, 826 F.Supp. 460, 464 (N.D.Ga. 1993), *aff'd*, 21 F.3d 1126 (11th Cir. 1994); *S.E.C. v. Shiell*, No. 76-204, 1977 WL 1044 at *2-3 (N.D. Fla. Sept. 27, 1977); *see also Schnell v. City of Chicago*, 407 F.2d 1084, 1085 (7th Cir. 1969).

III. SECTION 10(b) and RULE 10b-5 CLAIMS

Section 10(b) of the Securities Exchange Act makes it unlawful for any person, directly or indirectly, to use in connection with the mails or facilities of interstate commerce any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the

Commission may prescribe. . . . " 15 U.S.C. § 78j. The SEC has adopted Rule 10b-5 which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or (3) to engage in any art, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

To state a claim upon which relief can be granted for federal securities fraud under Rule 10b-5, a plaintiff must allege that "in connection" with the purchase or sale of securities: (1) the defendant made a false statement or omission of material fact; (2) with scienter; (3) upon which the plaintiff justifiably relied; and (4) that caused the plaintiff to suffer injury. *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997); *Bruschi v. Brown*, 876 F.2d 1526, 1528 (11th Cir. 1989). The Plaintiffs rely upon the "fraud on the market" doctrine to show reliance. The doctrine's premise is that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, all material misrepresentations." *Basic Inc. v. Levinson*, 485 U.S. 224, 246, 108 S.Ct. 978, 991, 99 L.Ed.24 194 (1988). In the context of these Motions to Dismiss, the Defendant does

not challenge the Plaintiffs' reliance on the fraud on the market doctrine.

A. FALSE STATEMENTS OR OMISSIONS

The Plaintiffs allege that the Defendant made several false and misleading statements in connection with the audit opinion of Medaphis' 1995 financial statements, including the fourth quarter financial results. They further allege that the Defendant made false statements in connection with overstating revenues in Medaphis' 1996 first quarter report. The Defendant first contends that its Motion to Dismiss must be granted with respect to the overstatement of first quarter 1996 earnings (booking $12.5 million in revenue before it was earned) because the earnings reports were unaudited and no statement was made by it to the public regarding the 1996 earnings. The Defendant contends that its alleged conduct regarding the first quarter 1996 conduct amounts to nothing more than aiding and abetting liability, which is not actionable under Rule 10b-5.

In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed. 2d 119 (1994), the Supreme Court considered whether private civil liability under Section 10(b) extends to those who do not engage in the manipulative or deceptive device, but who instead aid and abet the violation. *Id.* at 167, 114 S.Ct. at 1443. After examining the text of the statute, the Supreme Court concluded that Congress never intended to impose secondary liability under Section 10(b) and the statute therefore "does not itself reach those who aid and abet a § 10(b) violation." *Id.* at 177, 114 S.Ct. at 1448.

According to the Supreme Court, the statute "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Id.* The Supreme Court did not hold that secondary actors in the securities market are always free from liability under the Securities Act. Rather, "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under [Rule] 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." *Id.* at 191, 114 S.Ct. at 1455.

Since the decision in *Central Bank*, the federal courts have split over the threshold required to show that a secondary actor's conduct constitutes primary liability. The Eleventh Circuit has yet to consider this issue. In *In re Software Toolworks, Inc.*, 50 F.3d 615 (9th Cir. 1994), *cert. denied*, 516 U.S. 907 (1995), the Ninth Circuit held that secondary third parties may be primarily liable for statements made by others in which the third party significantly participated. *Id.* at 628 n.3 (an accountant may be primarily liable based on its "significant role in drafting and editing" a letter sent by the issuer to the SEC). By contrast, the Second Circuit has determined that more than significant participation by the secondary actor is needed to incur primary liability. *See Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*"). In noting that a defendant must "make" a false or misleading statement, the Second Circuit has held:

> [A] secondary actor cannot incur primary liability under the [Securities] Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the Act, as "[r]eliance only on representations made by others cannot itself form the basis of liability." Thus, the misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision.

Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).

Attached to the Plaintiffs' response to the Defendant's motion is an *amicus* brief of the SEC. (Doc. No. 50, Exh. C). In that *amicus* brief filed in connection with another securities litigation case, the SEC urges the courts to adopt a standard for primary liability by secondary actors that falls in between the Second and Ninth Circuits. In the wake of *Central Bank*, the SEC urges that an entity can be primarily liable when it, acting alone or with others, creates a misrepresentation. (Doc. No. 50, Exh. C at 16-17). To be liable, a defendant does not necessarily have to be identified to investors. (*Id.* at 16). The SEC believes that the test should look to what a secondary actor does in "creating a misrepresentation" to determine when that actor makes a misrepresentation in violation of Section 10(b). The views of the SEC are entitled to consideration and some deference. *See Basic Inc.*, 485 U.S. at 239, fn 16, 108 S.Ct. at 987. This Court adopts the standard urged by the SEC and concludes that a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if

the misrepresentation is not publicly attributed to it. Under the Second Circuit standard, a secondary actor who is the actual creator and author of a material misstatement could avoid liability simply due to the concealment of its identity. The Court finds that there is nothing in *Central Bank* with regard to its use of the terms "makes" or "making a material misstatement" that limits liability to those individuals who sign documents or are otherwise identified to investors. The standard adopted by the Court is consistent with the "directly or indirectly" language in Section 10(b).

With regard to the overstatement of 1996 first quarter earnings, the Plaintiffs allege in the Amended Complaint that the Defendant "specifically directed the inclusion of $12.5 million of revenues and income from the DeTe Mobil Contract" in the 1996 first quarter financial statements. The Court finds that the Plaintiffs have alleged more than aiding and abetting and have sufficiently alleged a primary violation of Rule 10b-5 against the Defendant with respect to the 1996 first quarter financial report of Medaphis. While the 1996 first quarter report does not identify the Defendant or otherwise attribute the inclusion of the $12.5 million to the Defendant, the Plaintiffs have sufficiently alleged that the Defendant created the misrepresentation by directing Medaphis to include that revenue and income in the report. More than mere participation, complicity, or assistance, the Plaintiffs have essentially alleged that the Defendant was the author of the alleged misstatement. Accordingly, the Court does not dismiss the allegations in the Amended Complaint with respect to the overstatement of first quarter 1996 earnings.

The Defendant next contends that the allegations in the Amended Complaint with respect to the audited 1995 earnings report and unaudited 1996 first quarter earnings report should be dismissed for failure to comply with Rule 9(b) and the heightened-pleading standards of the Reform Act. The Court must look to the Amended Complaint to determine whether the elements of a 10b-5 fraud action have been properly pled. Complaints alleging fraud must meet the heightened-pleading standards of Rule 9(b), which requires that "in all averments of fraud or mistake the circumstances constituting fraud or mistake shall be stated with particularity." Fed.R.Civ.P. 9(b). A fraud claim meets the requirements of Rule 9(b) if it sets forth precisely what statements or omissions were made in what documents or oral presentations, who made the statements, the time and place of the statements, the contents of the statements or manner in which they misled the plaintiff, and what the defendants gained as a consequence. *Brooks v. Blue Cross and Blue Shield of Florida*, 116 F.3d 1364, 1371 (11th Cir. 1997).

In adopting the Reform Act, the Congress found that Rule 9(b) was not sufficient to prevent the filing of abusive private securities fraud actions. Among other things, the Reform Act changed the pleading standards for alleging fraud in securities class action lawsuits. The Reform Act requires a securities-fraud plaintiff to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). If an allegation regarding a statement or omission is made on information and belief, the complaint must state with particularity the facts on which the belief is formed. *Id.* Further, as to each statement or

omission, the plaintiff must set forth particular facts that give rise to a strong inference that the defendants acted with the required state of mind. 15 U.S.C. § 78u-4(b)(2). A complaint that fails to comply with any of these requirements must be dismissed. 15 U.S.C. § 78u-4(b)(3)(A).

To state a claim for accounting fraud, a plaintiff must adequately plead facts sufficient to support a conclusion that the defendant prepared false financial statements, and that the alleged financial fraud was material. *Zeid v. Kimberley*, 973 F.Supp. 910, 922 (N.D. Cal. 1997). Although the complaint need not specify the exact dollar amount of each accounting error, it must identity particular transactions underlying the alleged accounting irregularities. *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 926-27 (9th Cir. 1993), *cert. denied*, 513 U.S. 917 (1994). Violations of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards may constitute false or misleading statements of material fact in violation of Rule 10b-5. *See Gross v. Medaphis Corp.*, 977 F.Supp. 1463, 1472 (N.D.Ga. 1997); *In re Discovery Zone Securities Litig.*, 943 F.Supp. 924, 936-37 (N.D.Ill. 1996); *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*, 927 F.Supp. 1297, 1305 (C.D.Cal. 1996); *Simpson v. Specialty Retail Concepts, Inc.*, 908 F.Supp. 323, 329 (M.D.N.C. 1995); *Lerch v. Citizens First Bancorp., Inc.*, 805 F.Supp. 1142, 1154-55 (D.N.J. 1992).

In the Amended Complaint, the Plaintiffs claim that the Defendant artificially inflated and supported Medaphis' stock price by materially misleading the public with respect to revenue recognition and false reporting of expenses in connection with the 1995 and 1996 first quarter earnings reports. The Plaintiffs claim that the

false reporting of expenses and income led directly to the acquisition of companies, such as HDS, with that artificially-inflated stock. The Plaintiffs allege several specific violations of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards in connection with the Defendant's audit of the 1995 earnings report that was disseminated to the shareholders. With respect to the audit opinion, the Plaintiffs allege that the Defendant violated Generally Accepted Auditing Standards principles in connection with the revenue recognition of $3.5 million. The Plaintiffs allege that the Defendant, contrary to its representation in the 1995 earnings report of conformance to Generally Accepted Auditing Standards principles, failed to obtain direct confirmation from the Bertelsmann subsidiary that the subsidiary actually owed the $3.5 million in 1995. They further allege that the Defendant violated Generally Accepted Accounting Principles in connection with the 1995 earnings report by (1) understating expenses by over $4 million; and (2) overstating and recognizing income from the Software Licensing Agreement and other systems integration contracts. The Plaintiffs further allege that Defendant violated Generally Accepted Accounting Principles in connection with the 1996 first quarter earnings report by expressly directing the improper inclusion of $12.5 million in revenue from the DeTe Mobil Contract. The Court finds that these claims are set forth with sufficient particularity to support a claim of securities fraud against the Defendant. Accordingly, when viewing every allegation in the Amended Complaint as true, the Court finds that the Plaintiffs have made sufficient allegations of securities fraud against the Defendant to constitute

false or misleading statements for the purposes of a Rule 10b-5 claim.

B. MATERIALITY

Materially misleading statements or omissions by a defendant constitute the primary element of a Rule 10b-5. *Basic Inc.*, 485 U.S. at 246-47, 108 S.Ct. at 991-92. A false statement or omission will be considered "material" if its disclosure would alter the total mix of facts available to an investor and "if there is a substantial likelihood that a reasonable shareholder would consider it important" to the investment decision. *Id.* Materiality is a mixed question of law and fact. *Goldman v. Belden*, 754 F.2d 1059, 1067 (2nd Cir. 1985). A complaint may not be dismissed under Rule 12(b)(6) unless the alleged misstatements and omissions are "so obviously unimportant to a reasonable investor that reasonable minds could differ on the question of their importance." *Id.* When viewing the allegations in the Amended Complaint as true, the alleged false misrepresentations in connection with the 1995 earnings report and the 1996 first quarter earnings report are clearly not so unimportant that reasonable minds could not differ as to their materiality. The Plaintiffs allege that the false representations in the financial reports allowed Medaphis to continue portraying itself as a profitable and growing company. If the allegations in the Amended Complaint are true, Medaphis' earnings were declining in 1995 and were nonexistent in the first quarter of 1996. This was concealed from investors by fraudulent misrepresentations. Whether earnings are increasing or decreasing is highly material to investors. Accordingly, the

Plaintiffs have sufficiently pled the element of materiality as to the Defendant.

C. SCIENTER

The Plaintiff must properly allege scienter in order to state a claim pursuant to Section 10(b) and Rule 10b5. The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, 96 S.Ct. 1375, 1380, 47 L.Ed.2d 668 (1976). Before the enactment of the Reform Act, the law in the Eleventh Circuit was clear that "a showing of 'severe recklessness' satisfies the scienter requirement." *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989).[2]

> Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

Id. (*quoting Broad v. Rockwell International Corp.*, 642 F.2d 929, 961 (5th Cir.) (*en banc*), *cert. denied*, 454 U.S. 965, 102 S.Ct. 506, 70 L.Ed. 2d 380 (1981)), in the Eleventh Circuit, there was no special pleading standard for securities fraud actions.

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[2] Both sides cite this case as setting forth the law in the Eleventh Circuit.

Prior to the Reform Act, the Second Circuit adopted a special heightened pleading standard for securities fraud cases. It held that "to serve the purposes of Rule 9(b), we require plaintiffs to allege facts that give rise to a strong inference of fraudulent intent." *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2nd Cir. 1994). However, in some cases, it also held that a plaintiff could satisfy this heightened pleading standard by alleging (1) facts constituting strong circumstantial evidence of reckless or conscious misbehavior, or (2) facts showing that the defendants had both motive and opportunity to commit fraud. *Id.* Arguably, the "motive and opportunity" standard for alleging scienter lowered the bar more than the heightened pleading standard raised it. In practice, the Second Circuit applied the "motive and opportunity" standard in such a way that it is questionable whether there really were two ways of alleging scienter. In other words, without a showing of conduct sufficient to infer fraudulent intent, the Second Circuit always found insufficient showing of motive and opportunity to establish scienter. *See Shields*, 25 F.3d at 1130-31; *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 269-272 (2nd Cir. 1993). Thus, in the Second Circuit, there was a heightened-pleading requirement but, at least in theory, a reduced standard as to the state of mind that must be alleged and proven to establish scienter.

The Reform Act requires that plaintiffs must set forth as to each statement or omission particular facts that give rise "to a strong inference that the defendants acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The application of the Reform Act's standard has produced considerable debate in the district courts as to whether

the Reform Act has adopted all or part of the Second Circuit standards for pleading scienter in securities fraud actions. Since the Reform Act's enactment, several courts have held that the Reform Act's requirements for pleading scienter is consistent with all aspects of the Second Circuit's jurisprudence. *See Fugman v. Aprogenex Inc.*, 961 F. Supp. 1190, 1195 (N.D. Ill. 1997); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1250-53 (N.D. Ill. 1997); *Marksman Partners*, 927 F. Supp. at 1311. In determining that the Reform Act adopts both aspects of the Second Circuit standard, the court in *Rehm* cited a report from the Senate Banking, Housing, and Urban Affairs Committee on the Reform Act's passage which stated:

> The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. . . . The Committee does not intend to codify the Second Circuit's caselaw interpreting this pleading standard, although courts may find this body of law instructive.

Rehm, 954 F.Supp. at 1252 (*quoting* S.Rep.98, 104th Cong., 1st Sess. 15 (1995)).

Conversely, other courts have concluded that Congress intended to strengthen the Second Circuit standard by holding that the "motive and opportunity" prong of the Second Circuit's pleading standard no longer suffices to raise a strong inference of scienter. *See In re Silicone Graphics, Inc. Securities Litigation*, 970 F.2d 746, 757 (N.D. Ca. 1997); *Norwood Venture Corp. v. Converse Inc.*, 959 F.Supp. 205, 208 (S.D.N.Y. 1997). The courts in *Silicone*

Graphics and *Norwood* noted a House Conference Report which stated that Congress intended to "strengthen the existing pleading requirements" and did "not intend to codify the Second Circuit's case law interpreting this pleading standard." *Silicone Graphics*, 970 F.Supp. at 756; *Norwood*, 959 F.Supp. at 208 (*quoting* H.R. Conf. Rep. No. 104-369, 104th Cong., 1st Sess. 41 (1995)). Moreover, these courts relied upon President Clinton's veto of the Reform Act, a veto that Congress overrode, in which the President stated that it was "crystal clear" that Congress intended the Reform Act to go beyond the Second Circuit standard. *Silicone Graphics*, 970 F.Supp. at 756, *Norwood*, 959 F.Supp. at 208. With regard to the first prong of the old Second Circuit standard, the courts in *Silicone Graphics* and *Norwood* relied on this legislative history in determining that a Plaintiff must show more than strong circumstantial evidence of reckless behavior. *See Silicone Graphics*, 970 F.Supp. at 756-57; *Norwood*, 959 F.Supp. at 208-09; *see also Powers v. Eichen*, 977 F.Supp. 1031, 1038-39 (S.D.Cal. 1997). Thus, to establish scienter, these courts hold that the plaintiff must set forth facts that "create a strong inference of knowing or intentional misconduct" on the part of the defendants. *Silicone Graphics*, 970 F.2d at 757. The courts in *Norwood* and *Silicon* therefore hold that the Reform Act intended a higher pleading requirement than that of the Second Circuit by not codifying its motive, opportunity and recklessness standards.

While holding that Congress eliminated the "motive and opportunity" prong under the Reform Act, other courts have held that a plaintiff may still plead facts showing strong circumstantial evidence of reckless behavior. *See In re Stratosphere Securities Litigation*, 1

F.Supp.2d 1096, 1107 (D.Nev. 1998); *Novak v. Kasaks*, 997 F.Supp. 425, 430 (S.D.N.Y. 1998); *In re Baesa Securities Litigation*, 969 F.Supp. 238, 240-42 (S.D.N.Y. 1997). In *Baesa Securities*, the court focused on the statutory language of § 78u-4(b)(2) which requires plaintiff to set forth as to each statement or omission particular facts that give rise to a strong inference that the defendants acted with the requisite scienter. The court concluded that nothing in this statute eliminated the recklessness aspect of the scienter requirement. *Id.* at 241. While adopting the "strong inference" requirement, the court concluded that the statute neither mentions "motive and opportunity" nor singles out any other special particulars sufficient to show scienter. *Id.* at 242. Because the statutory language is clear, the court concluded that it was neither necessary nor prudent to resort to the Reform Act's convoluted legislative history. *Id.* at 241-42.[3]

The Court is persuaded that the approach of *Baesa Securities* is the proper one. The Reform Act does what it says it does – no more and no less. The Act incorporates the heightened-pleading standard of the Second Circuit in that it requires the plaintiff to set forth particular facts that give rise to a strong inference that the defendant acted with "the required state of mind." 15 U.S.C. § 78u-4(b)(2). However, the Act did nothing to change "the required state of mind" with respect to this type of

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[3] A fourth set of cases have dodged the issue. *Gross*, 977 F.Supp. at 1472; *In re ValuJet, Inc. Securities Litigation*, 984 F.Supp. 1472 (N.D. Ga. 1997); *In re Miller Industries, Inc. Securities Litigation*, 12 F.Supp 2d 1323 (N.D. Ga. 1998). The issue cannot be dodged in this case.

action. This conclusion is consistent with the Conference Committee Report on the Reform Act which stated that the Committee strengthened pleading requirements, but "chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." H.R. Conf. Rep. No. 104-369, 104th Cong. 1st Sess. 41 (1995). It is also consistent with the Joint Explanatory Statement of the Committee of Conference Regarding S. 1260, the Securities Litigation Uniform Standards Act of 1998. In that Statement, the Conference Committee stated –

> It is the clear understanding of the managers that Congress did not, in adopting the Reform Act, intend to alter the standards of liability under the Exchange Act. The managers understand, however, that certain Federal district courts have interpreted the Reform Act as having altered the scienter requirement. In that regard, the managers again emphasize that the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act or S. 1260 in any way alters the scienter standard in Federal securities fraud suits. Additionally, it was the intent of Congress, as was expressly stated during the legislative debate on the Reform Act, and particularly during the debate on overriding the President's veto, that the Reform Act established a heightened uniform Federal standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the Reform Act itself carefully provides that plaintiffs must "State with particularity facts giving rise to a strong inference that the defendant acted with the required

> state of mind." The Managers emphasize that neither the Reform Act nor S. 1260 makes any attempt to define that state of mind.

After careful review of the legislative history of the Reform Act, the Court is convinced that the Second Circuit's two pronged standard of (1) motive and opportunity or (2) conscious misbehavior or recklessness relate to the definition of state of mind and are not incorporated in or repealed by the Reform Act.

As noted above, the Eleventh Circuit has clearly defined the state of mind required to establish scienter in a securities fraud action. This Court is bound by Eleventh Circuit precedent and not by the caselaw of the Second Circuit. The Eleventh Circuit has never adopted a scienter standard that follows the "motive and opportunity" analysis of the Second Circuit. A good argument can be made that the "motive and opportunity" standard, if honestly applied, lowers the bar for securities fraud cases below that mandated by the Supreme Court in *Hochfelder*. Greed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and manipulate. Furthermore, allowing private securities class actions to proceed to discovery upon bare allegations of motive and opportunity would upset the delicate balance of providing a remedy for genuine fraud while preventing abusive strike suits that the Reform Act sought to achieve. Motive and opportunity will ordinarily be relevant, and often highly relevant, to a finding of fraudulent intent. However, the Court concludes that a showing of motive and opportunity alone are insufficient to allege securities fraud under the "severe recklessness" standard established by the Eleventh Circuit.

For the same reasons, the Court rejects the argument that the Reform Act requires a showing of intentional misconduct or conscious misbehavior. "[W]here Congress intended to establish knowing conduct as a prerequisite for liability, it did so explicitly within the Reform Act, such as providing a safe harbor for forward looking statements." *Stratosphere Securities*, 1 F.Supp.2d at 1107 (citing 15 U.S.C. § 77z-2(c)(1)(B); 15 U.S.C. § 78u-5(c)(1)(B)). These provisions regarding forward-looking statements would be rendered meaningless if actual knowledge were required for all allegedly misleading statements. *Stratosphere Securities*, 1 F.Supp.2d at 1107. Because recklessness is sufficient to prove scienter under the Reform Act unless the statute expressly provides otherwise, the Court concludes that a plaintiff can properly plead scienter by alleging facts constituting strong circumstantial evidence of severe recklessness or conscious misbehavior.[4]

In this case, the Court finds that the Plaintiffs have adequately alleged that the Defendant recklessly or consciously misrepresented the revenues, expenses, and earnings of Medaphis to keep the stock high for the acquisition of other companies like HDS. While alleging a misapplication of Generally Accepted Accounting Principles standing alone is insufficient, such allegation when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter. *See Gross*,

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[4] The Court has reached the same conclusion in *Sturm v. Marriott Marquis Corp.*, Case No. 97-CV-3706 TWT (Order dated November 13, 1998).

977 F.Supp. at 1472; *Rehn*, 954 F.Supp. at 1255-56. According to the Amended Complaint, the Defendant was not just an auditor. It was heavily involved in the management of Medaphis and had unrestricted access to its financial records and data. If the allegations of the Amended Complaint are true, the Defendant knew that its client was understating expenses and improperly recognizing revenue. As discussed above, the Plaintiffs have alleged numerous Generally Accepted Accounting Principles and Generally Accepted Auditing Standards violations against the Defendant, an accounting expert, which combined to have a dramatic effect on the financial results of Medaphis for 1995 and the first quarter of 1996. Defendant contends that any departures from Generally Accepted Accounting Principles (for example, understatement of expenses) were immaterial. However, accepting the allegations of the Amended Complaint as true, but for these alleged accounting rule violations, Medaphis could not have perpetuated its image as a high growth stock. The overstatement of Medaphis' financial condition, in turn, helped to allow Medaphis the opportunity to acquire other companies based on its artificially-inflated stock prices.

The allegations of the Amended Complaint, if true, establish more than mere mistakes in the exercise of professional judgment or negligence. If true, they are sufficient to show severe recklessness As alleged in the Amended Complaint, the end of quarter revenue manipulations in 1995 and 1996 were highly suspicious, and a prudent auditor would have been on notice to inquire further even if it was not directly responsible for the manipulations. *See* 15 U.S.C. § 78J-1(a)(l) (as to 1996 only).

The allegations of the Amended Complaint are at least as specific and particular as those in the *Medaphis* action that survived a motion to dismiss. Accordingly, when viewing the allegations of the Amended Complaint as true, the Court concludes that the allegations concerning the totality and magnitude of the Defendant's accounting violations constitute strong circumstantial evidence of reckless or conscious misbehavior.

D. CAUSATION

The Plaintiffs must prove both actual causation (transaction causation) and proximate causation (loss causation) to prevail on their Rule 10b-5 claims. *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989). To plead transaction causation sufficiently, the Plaintiffs can allege that the Defendants' misrepresentations or omissions induced the Plaintiffs to make the investment. *In re Checkers Securities Litig.*, 858 F.Supp. 1168, 1177 (M.D.Fla. 1994). To plead loss causation sufficiently, the Plaintiffs can allege they would not have invested had they known the truth, and that the untruth was in some reasonable direct way responsible for the loss. *Id.* A review of the Amended Complaint reveals that the Plaintiffs have adequately pled both actual and loss causation. Accordingly, the Defendant's Motion to Dismiss the Plaintiffs' Rule 10b-5 Claim is denied.

IV. SECTION 11 CLAIM

In Count II of the Complaint, the Plaintiffs allege violations of Sections [sic] 11 of the Securities Act, 15 U.S.C. §§ 77k. This section imposes liability on signers of

a registration statement if the statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading," 15 U.S.C. § 77k. This section provides buyers with a cause of action against those who sell securities by means of a registration statement or a prospectus when those documents contain material misstatements or omissions. The Supreme Court has stated that Section 11 only applies when a document solicits the public to acquire securities. *John Nuveen & Co. Inc. v. Sanders*, 450 U.S. 1005, 1008, 101 S.Ct. 1719, 1720 (1981).

The Sub-Class Plaintiffs' Section 11 claim refers to Medaphis' acquisition of HDS based on information contained in the HDS Registration Statement and Prospectus. These Plaintiffs allege that they acquired Medaphis stock based on the Defendant's misrepresentations as to the audited 1995 earnings report which was incorporated into the HDS Registration and Prospectus. The Defendant does not challenge whether the HDS Registration Statement and Prospectus solicited the public to acquire securities. Rather, in moving to dismiss the Section 11 claim, the Defendant contends that the Plaintiffs have failed to plead this claim with sufficient particularly under Rule 9(b). In view of the discussion above in connection with the Rule 10b-5 claim, the Court finds that the Plaintiffs have sufficiently alleged their Section 11 claim. Accordingly, the Defendant's Motion to Dismiss this claim is denied.

V. STATUTE OF LIMITATIONS

The Plaintiffs filed their original Complaint on October 21, 1997. In its Motion for Judgment on the Pleadings or to Dismiss, the Defendant contends that before October 22, 1996, the public domain included the August 14, 1996, press release and Form 10-Q that announced the write-offs of revenue from the DeTe Mobil Contract that had been recognized in the first quarter of 1996. The Defendant contends that this announcement, when combined with the resulting drop in the Medaphis stock price and the filing of 19 related federal securities class actions, sufficiently placed the Plaintiffs on inquiry notice of a securities fraud claim against the Defendant. The Defendant further contends that the August 14, 1996, press release placed the Plaintiffs on actual notice of the claims relating to the improper revenue recognition in the 1996 first quarter earnings report in connection with the DeTe Mobil Contract. Plaintiffs contend that they were not on notice as to the Defendants' liability, in part because Defendant and Medaphis lied about the reasons for restating the 1995 results and the losses in 1996.

Securities-fraud claims under Rule 10b-5 must be brought within one year after discovery of the facts constituting the violation and within three years after the violation, 15 U.S.C. § 77m; *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gibertson*, 501 U.S. 350, 364, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991). The statute begins to run when the plaintiff "has either knowledge of the violation or notice of facts which, in the exercise of due diligence, would have led to actual knowledge thereof." *Knight v. E.F. Hutton & Co.*, 750 F.Supp. 1109, 1112 (M.D. Fla. 1990) *(quoting Vigman v. Community Nat. Bank & Trust Co.*, 635

F.2d 455 (5th Cir. 1981)). "[Q]uestions of notice and due diligence are particularly suited for a jury's consideration." *Kennedy v. Tallant*, 710 F.2d 711, 716 (11th Cir. 1983). With respect to the factual issue of due diligence, courts must look to the state of mind of the plaintiff shareholder. *Durham v. Business Management Associates*, 847 F.2d 1505, 1509 (11th Cir. 1988). Plaintiffs are not charged with inquiry notice until they knew or should have known that the Defendant acted with the requisite scienter. *See Law v. Medco Research, Inc.*, 113 F3d 781, 786 (7th Cir. 1997). The Defendant bears the burdens of production and persuasion as to a statute of limitations defense. *Smith v. Duff and Phelps, Inc.*, 5 F.3d 488, 492, n.9 (11th Cir. 1993).

In this case, the Court cannot determine for purposes of this motion that the one year limitations period bars any of the Plaintiffs' claims. While the August 14, 1996, press release and the subsequent filing of 19 related lawsuits may have created suspicious circumstances as to the Defendant's conduct, the Court cannot conclude as a matter of law that they provided inquiry notice of the Defendant's reckless or intentional misconduct. Further, the press release and related lawsuits did not conclusively provide the Plaintiffs with actual notice of the Defendant's conduct related to the DeTe Mobil Contract. In order to show that the limitations period applies, the Defendant improperly relies upon evidence not referenced in the pleadings. The Defendant, therefore, has failed to establish as a matter of law that the Plaintiffs were placed on either actual or inquiry notice of any of the Plaintiffs' claims before October 22, 1996. While the Defendant's Motion for Judgment on the Pleadings or to

Dismiss is denied, the statute of limitations issue may be revisited on a motion for summary judgment.

VI. CONCLUSION

The Plaintiffs' Motions for Leave to File Sur-Reply Memoranda [Doc. Nos. 55 and 56] are GRANTED. The Defendants' Motion to Dismiss the Amended Complaint [Doc. No. 40] and Motion for Judgment on the Pleadings or to Dismiss [Doc. No. 41] are DENIED.

SO ORDERED, this 13 day of November, 1998.

/s/ Thomas W. Thrash
THOMAS W. THRASH, JR.
United States District Judge

Nos. 97-1143; 97-1261

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

ELYSE S. KLEIN, RICHARD KASTNER, DORIS KASTNER, and WARREN KASTNER,

Appellants,

v.

WILLIAM BALLANTINE BOYD, III, WILLIAM DISSTON COLEMAN, THOMAS H. TARANTINO, LAWRENCE G. STEVENS, GREGORY JAMGOCHIAN, DRINKER, BIDDLE & REATH, MERCER SECURITIES, INC., and MERCER SERCURITIES, LTD.,

Appellees.

On Appeal from the United States District Court
for the Eastern District of Pennsylvania

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

RICHARD H. WALKER
General Counsel

JACOB H. STILLMAN
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Appellees.

On Appeal from the United States District Court
for the Eastern District of Pennsylvania

BRIEF OF THE SECURITIES
AND EXCHANGE COMMISSION,
AMICUS CURIAE

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief, *amicus curiae*, to address an important question concerning liability in private lawsuits, and possibly certain Commission actions, brought under the antifraud provisions of the federal securities laws:

> Is a person who makes a material misrepresentation, while acting with the requisite scienter, but who does not himself disseminate the misrepresentation to investors, and whose name is not made known to them, only an aider and abettor of the fraud, or is that person a primary violator subject to liability?

In the Commission's view, such a person is a primary violator of the antifraud provisions.

The question arises because the Supreme Court, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), ruled that private actions cannot be brought against persons who aid and abet violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, but only against "primary violators." The Supreme Court, however, expressly stated that persons like lawyers, accountants, bankers, or others who provide services to the central figures in a fraud, can be liable in private actions as primary violators, along with the central figures, when such "secondary actors" make misrepresentations. 511 U.S. at 191. This case involves the circumstances under which a law firm may be

deemed to have "made" misrepresentations and thus may be adjudged to be a primary violator.

Meritorious private actions under the federal securities laws serve an important role, both because they provide compensation for investors who have been harmed by securities law violations and because, as the Supreme Court has repeatedly recognized, they "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.' " *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985), quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). *See also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). Congress, in adopting the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, affirmed that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses" and that private lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Congress, 1st Sess. 31 (1995).

The Commission has a further interest in this case, beyond its implications for private actions. Because *Central Bank* was a private action, the Supreme Court did not explicitly address the Commission's authority to bring actions against aiders and abettors. After *Central Bank*, Congress reaffirmed the Commission's authority to bring such actions in the Litigation Reform Act. Securities Exchange Act Section 20(f), 15 U.S.C. 78t(f). Nonetheless, a decision in this case delineating the circumstances in

which a person is a primary violator could affect the Commission's litigating authority in several areas.

First, assuming the *Central Bank* holding applies to the Commission, the courts have not resolved (except in one circuit[1]) whether the Congressional reaffirmation of the Commission's aiding and abetting authority is to be applied retroactively. Thus, it is unclear whether the Commission may proceed against persons as aiders and abettors whose fraudulent conduct occurred before Congress enacted the Litigation Reform Act. Second, the provision in the Litigation Reform Act reaffirming the Commission's authority to sue aiders and abettors requires a showing that the defendant provided assistance knowingly, thus raising a question about whether the scienter element in a securities fraud action against an aider and abettor can be satisfied by the reckless conduct that is sufficient to make a defendant liable as a primary violator. Third and finally, this case could have a bearing upon the Commission's authority to proceed against violators of the antifraud provisions of the Securities Act of 1933, 15 U.S.C. 77a et seq. The Supreme Court's rejection of aiding and abetting liability under Section 10(b) of the Securities Exchange Act could be applied to the Securities Act as well. The Litigation Reform Act, however, does not give the Commission authority to proceed against aiders and abettors of violations of the Securities Act.

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[1] *See SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996), *cert. denied*, 118 S.Ct. 59 (1997).

STATEMENT OF THE CASE

1. The Facts

Defendant Drinker Biddle & Reath, a Philadelphia law firm, was retained in 1992 by William Coleman, a securities salesman with a long history of regulatory troubles and customer complaints, to assist in setting up a brokerage firm, Mercer Securities, Ltd. District Court slip op. at 4-5.

The plaintiffs, who were social acquaintances and customers of Coleman, made two series of limited partnership investments in Mercer. *Id.* at 2, 3-5. Only the second series is at issue in this case. The first series, however, is relevant because it bears on whether Drinker Biddle & Reath knew of Coleman's disciplinary history and the customer complaints against him.

In the first series of investments, in the fall of 1992, the plaintiffs were solicited by Coleman and invested money before the law firm had completed the partnership agreement and accompanying disclosure documents. *Id.* at 3. In February 1993, Drinker Biddle & Reath completed a disclosure package for investors that included details of outstanding state supervisory orders and judgments entered against Coleman. *Id.* at 4. The law firm gave the package to a principal of Mercer to give to investors. *Ibid.*

When the law firm partner handling Mercer matters learned some months later that the disclosure package had not been given to the investors, he urged Mercer officials to forward the information to them immediately. *Id.* at 5. The plaintiffs allege that they never received the February disclosure package. *Id.* at 4.

In the fall of 1993, Coleman solicited the plaintiffs to make further investments in Mercer. *Id.* at 5. For this second series of investments, Drinker Biddle & Reath prepared a new disclosure package, which the plaintiffs were given. *Ibid.* The plaintiffs allege that the new disclosure package, unlike the first one, did not contain information about outstanding state supervisory orders, judgments entered, and customer complaints against Coleman. *Id.* at 6.[2] The cover letter transmitting the new disclosure package was signed by a Mercer principal, not by Drinker Biddle & Reath, and the law firm's name did not appear in the documents in the disclosure package. *Ibid.*

Mercer eventually failed and the plaintiffs lost the money they provided in the second series of investments. *Id.* at 9.

2. The District Court's Decision

The district court dismissed plaintiffs' Section 10(b) and Rule 10b-5 securities fraud claim against Drinker Biddle & Reath because, even though the law firm had prepared documents that were given to investors, it did

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[2] Plaintiffs allege that the second disclosure package concealed adverse facts about Coleman, including his censure by the Chicago Board of Options Exchange, consent orders with Vermont and Minnesota barring him from certain broker-dealer positions, a four-year bar imposed by California preventing him from holding any position as a broker-dealer or investment advisor, his long history of customer complaints of fraudulent conduct, and Mercer's agreement with the National Association of Securities Dealers to limit his conduct with clients. *Id.* at 6.

not sign those documents and its name did not appear in them. *Id.* at 64-65. The district court noted that the plaintiffs had no direct communication with the law firm and did not know that it was involved with Mercer. *Id.* at 65.

The district court also ruled that the plaintiffs had not presented sufficient evidence to create a genuine issue of material fact as to whether Drinker Biddle & Reath had scienter. *Id.* at 65-68.

3. The Panel's Decision

A panel of this Court reversed the district court's grant of summary judgment on the federal securities fraud claim. The panel noted that when the Supreme Court ruled in *Central Bank* that there was no private cause of action for aiding and abetting, it was careful to state that there could still be liability for "secondary actors" – i.e., "those who provide services to participants in the securities business" (*Central Bank*, 511 U.S. at 188). Panel slip op. at 15. Such a secondary actor can be liable if he or she " 'makes a material misstatement (or omission) on which a purchaser or seller of securities relies.' " *Id.* at 15, quoting *Central Bank*, 511 U.S. at 191.

The panel held that, despite the fact that Drinker Biddle & Reath was not identified in any of the documents that went to investors, it could be liable because

> "lawyers and other secondary actors who significantly participate in the creation of their client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors of those misrepresentations, should be held accountable as primary violators under section

> 10(b) and Rule 10b-5 even when the lawyers or other secondary actors are not identified to the investors, assuming the other requirements of primary liability are met."

Id. at 18. When a lawyer elects to speak, the panel stated, he or she has a duty to speak truthfully, even when speaking "behind the scenes." *Id.* at 20. A lawyer who prepares a document knowing that it will be given to investors "has elected to speak to the investors, even though the document not may be facially attributed to the lawyer." *Ibid.*

In response to Drinker Biddle & Reath's argument that the plaintiffs had not shown reliance because they did not know of the law firm's involvement, the panel held that the federal securities laws require a plaintiff to demonstrate "reliance on the misleading statement; they do not require the plaintiff to demonstrate that he or she relied on the defendant's role in the preparation or dissemination of the statement." *Id.* at 18 (emphasis in original).

The panel made clear that a lawyer who only provides "substantial assistance" to a client, and who could have been liable as an aider and abettor before *Central Bank* eliminated aiding and abetting liability in private actions, would not be liable under the panel's test. In the panel's view, a person "has done more than provide mere substantial assistance" when his or her involvement was "sufficiently significant that the [fraudulent] statement can properly be attributed to the person as its author or co-author." *Id.* at 20-21; *see also id.* at 22.

With respect to the law firm's scienter, the panel reversed the district court's ruling that the plaintiffs had not presented sufficient evidence to create a genuine issue of material fact. The panel stated that a trier of fact could reasonably find that the law firm knew that investors never received the earlier disclosure package that included material information about Coleman's regulatory difficulties, and that the law firm prepared the second disclosure package without including this information. *Id.* at 24. The panel also stated that a trier of fact could reasonably infer from the evidence that the law firm concealed this information so that the plaintiffs would not withdraw their investments, Mercer would remain solvent, and Drinker Biddle & Reath would not be exposed to liability as a result of "possible oversights in [its] representation of Mercer LP." *Id.* at 24-25.

ARGUMENT

I. A RULE THAT IMPOSES LIABILITY ONLY WHEN A PERSON IS IDENTIFIED TO INVESTORS IS INCONSISTENT WITH *CENTRAL BANK* AND THE LANGUAGE OF SECTION 10(b).

The Supreme Court cautioned in *Central Bank* that the elimination of aiding and abetting liability in private actions does not mean that only the central figure in a securities fraud is liable. The Supreme Court stated that "secondary actors" could be liable as well:

> "The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank,

> who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators * * * ."

511 U.S. at 191 (citations omitted) (emphasis added).[3]

The issue in this case is whether, as Drinker Biddle & Reath contends, the phrase "makes a material misstatement (or omission)" means that a law firm or other secondary actor can be primarily liable for a misrepresentation only if it signs the document containing the misrepresentation or is otherwise identified to investors. Drinker Biddle & Reath argues, in effect, that even if it prepared a disclosure package for investors that it knew was materially false or misleading, it cannot be liable under *Central Bank* because the disclosure package did not reveal its identity. Thus, in Drinker Biddle & Reath's view, "[p]articipation in the drafting, no matter how significant," cannot by itself result in liability. Rehearing Petition at 6.[4]

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[3] The phrase "employs a manipulative or deceptive device" is from Section 10(b); the phrase "makes a material misstatement (or omission)" follows the language of Rule 10b-5(b).

[4] In support of its position, Drinker Biddle & Reath cites, *inter alia*, *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996), and *Shapiro v. Cantor*, 123 F.3d 717, 720-21 (2d Cir. 1997). Rehearing Petition at 3, 5, n.3. Those cases, however, involved very different factual situations, and therefore do not provide guidance for this case. In *Anixter*, the

This view of *Central Bank* is incorrect. Nothing in *Central Bank* indicates that when the Supreme Court used the word "makes," it meant that only persons who sign documents or are otherwise identified to investors can be primarily liable. Indeed, such an interpretation would be inconsistent with the language of Section 10(b), which makes it unlawful "for any person, directly or indirectly * * * [t]o use or employ * * * any manipulative or deceptive device or contrivance." (Emphasis added.) A person who creates a misrepresentation, but takes care not to be identified publicly with it, "indirectly" uses or employs a deceptive device or contrivance and should be liable.

The rule Drinker Biddle & Reath proposes would have the unfortunate and unwarranted consequence of providing a safe harbor from liability for everyone except those identified with misrepresentations by name. Creators of misrepresentations could escape liability as long as they concealed their identities.[5] Not only outside lawyers would benefit from such a rule; others who are retained to prepare information for dissemination to

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defendant was an accounting firm that had actually signed fraudulent documents, and therefore was liable under any standard. In *Shapiro*, the defendant accounting firm was not alleged to have been involved in creating any misrepresentation, but only to have been aware that its client was making a misrepresentation.

[5] "Controlling persons" of those publicly identified as responsible for the misrepresentation would be liable under Section 20(a) of the Exchange Act, 15 U.S.C. 78t(a). However, a person can be a creator of a misrepresentation without controlling the person in whose name the misrepresentation is issued.

investors, including accountants and public relations firms, could immunize themselves by remaining anonymous. Indeed, in-house counsel and other corporate officials and employees could avoid liability for misrepresentations they created, as long as their identities were not made known to the public. In sum, by providing a safe harbor for anonymous creators of misrepresentations, a rule that imposes liability only when a person is identified with a misrepresentation would place a premium on concealment and subterfuge rather than on compliance with the federal securities laws.

Drinker Biddle & Reath contends that it was "the Supreme Court's clear intention in *Central Bank* to adopt a bright-line rule for imposing liability" in order to protect securities lawyers from being named as defendants in securities fraud suits. Rehearing Petition at 1, 6-7. While the Supreme Court was concerned that there should be limits on the liability of lawyers and others who provide services to the central figures in a securities fraud (*see* 511 U.S at 188-89), the bright line rule Drinker Biddle & Reath advocates, with its resulting unwarranted consequences, goes beyond any reasonable reading of *Central Bank*. The Supreme Court did not set forth a bright line rule for liability, much less one that turns on whether the identity of a defendant is disclosed. Indeed, the Supreme Court used the word "makes" in discussing the involvement that could lead to liability – a word that requires further interpretation, as the panel recognized. Panel Slip Op. at 15 (discussing the need "to clarify the circumstances

under which a statement may fairly be said to have been 'made' by a secondary actor").[6]

Drinker Biddle & Reath further contends that without a bright-line test, lawyers will be named as defendants in every securities fraud suit filed in this Circuit. *Id.* at 6-7. This contention, however, fails to take into account the scienter requirement, which gives lawyers (and other defendants) substantial protection against frivolous securities fraud lawsuits. In a Section 10(b) securities fraud suit, the plaintiff must both plead and prove that the defendant acted with scienter, defined by this Court to mean deliberately or recklessly. *Newton v. Dean Witter Reynolds, Inc.*, 135 F.3d 266, 273 (3d Cir. 1998) (en banc).

The scienter element has become particularly important at the pleading stage of a suit in light of a key provision of the Litigation Reform Act, which requires the plaintiff to "state with particularity facts giving rise to

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[6] Nor did the Supreme Court forbid a fact-oriented test, as Drinker Biddle & Reath contends, pointing to the Supreme Court's discussion of policy arguments against such a test. *See* Rehearing Petition at 6. Rather, the Supreme Court discussed those arguments only to make the point that the policy arguments that the Commission made in its *Central Bank* brief in favor of aiding and abetting liability were not determinative. Policy considerations, the Court stated, could be taken into account "to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." 511 U.S. at 188 (citations omitted). However, "[p]olicy considerations cannot override [the court's] interpretation of the text and structure of the Act." *Ibid.*

a strong inference that the defendant acted with [scienter]." Securities Exchange Act Section 21D(b)(2), 15 U.S.C. 78u-4(b)(2). This requirement means that a securities fraud plaintiff must state a strong and specific case in order to avoid dismissal of his or her claim. This protection substantially lessens the possibility that plaintiffs will be able to bring frivolous suits against lawyers. Moreover, the Litigation Reform Act provides for mandatory sanctions against plaintiffs who fail to comply with the pleading requirements. Securities Exchange Act Section 21D(c), 15 U.S.C. 78u-4(c). Thus, if the Court rejects Drinker Biddle & Reath's bright line test, it is unlikely that there will be a flood of lawsuits against lawyers in this Circuit.

Finally, Drinker Biddle & Reath contends that imposing liability on it when the investors did not know of its involvement in the creation of the misrepresentation would negate the element of reliance required in a private action for securities fraud. Rehearing Petition at 3, 6. This contention is incorrect. The reliance a plaintiff in a securities fraud action must plead is reliance on a misrepresentation, not on the fact that a particular person made that misrepresentation. The Supreme Court stated in *Central Bank* that liability exists where "[a]ny person or entity, including a lawyer, accountant, or bank * * * makes a material misstatement (or omission) on which a purchaser or seller of securities relies." 511 U.S. at 191 (emphasis added). Thus, the Court placed the focus on the misrepresentation, not on the fact that a particular person made it.

Drinker Biddle & Reath nonetheless points to the Supreme Court's statement that the argument made by

the plaintiffs in *Central Bank* " 'would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance.' " Rehearing Petition at 3, quoting 511 U.S. at 180. This problem, it asserts, will be present unless there is a requirement that a plaintiff rely on the person who makes the representation.

Drinker Biddle & Reath, however, does not quote the entire passage from *Central Bank*. The Supreme Court went on to say that "[w]ere we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180 (emphasis added). In *Central Bank*, the defendant, a bank that had been the indenture trustee for a defaulted bond issue, had not created any misrepresentations, but had failed to update the appraisal for land securing the bonds. The investors thus could not be said to have relied on any misrepresentations "made" by the bank. In contrast, the plaintiffs in this case allege that Drinker Biddle & Reath created the misrepresentations upon which the investors relied.

II. A PERSON SHOULD BE LIABLE AS A PRIMARY VIOLATOR OF THE SECURITIES LAWS WHEN HE OR SHE, ACTING ALONE OR WITH OTHERS, CREATES A MISREPRESENTATION.

As we have shown in Argument I, Drinker Biddle & Reath is incorrect in arguing that liability may be imposed only when a defendant is identified to investors. The correct standard, we submit, is that when a person,

acting alone or with others, creates a misrepresentation, the person can be liable as a primary violator – assuming, of course, that he or she acts with the requisite scienter.

While the Commission, as *amicus curiae*, takes no position as to the truth of the allegations in the complaint, under the Commission's standard those allegations, if proven to be true, would establish that Drinker Biddle & Reath was a primary violator of the antifraud provisions.

The Commission's proposed test makes clear that more than one person may be involved in creating a misrepresentation. As the Supreme Court stated in *Central Bank*, "[i]n any complex securities fraud * * * there are likely to be multiple [primary] violators." *See* 511 U.S. at 191. Moreover, it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else.

Under the Commission's test, however, a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the document and thus had the requisite scienter, he or she would not have created those misrepresentations.

The test proposed by the Commission differs somewhat from the test enunciated by the panel, which concluded that

> "lawyers and other secondary actors who significantly participate in the creation of their client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors of those misrepresentations, should be held accountable as primary violators under section 10(b) and Rule 10b-5 even when the lawyers or other secondary actors are not identified to the investor."

Panel slip op. at 18. In the Commission's view, the panel's phrase "significantly participate in the creation of their client's misrepresentations" is susceptible to misinterpretation. The phrase "significantly participate," although consistent with responsibility for the creation of a misrepresentation, could also be taken to encompass lesser degrees of involvement. Drinker Biddle & Reath argues that the panel's test would make defendants liable for conduct that is "indistinguishable" from the aiding and abetting conduct held to be not actionable in *Central Bank*. Rehearing Petition at 2-3. While the Commission does not agree with this view, it recognizes some potential for misinterpretation in the panel's formulation. *See Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank*."). The Commission believes that its proposed formulation – "creates a misrepresentation, acting alone or with others" – will help to avoid this difficulty.

In sum, the word "makes" as used in *Central Bank* does not have a precise meaning independent of the circumstances of the particular case. Drinker Biddle & Reath's test would define "makes" as "signs." But, as

noted earlier, nothing in *Central Bank* indicates that the Supreme Court meant to give such a restrictive definition to the word, and indeed, such a definition would be inconsistent with the "directly or indirectly" language of Section 10(b). The Commission believes that a test that looks to what a secondary actor does in "creating a misrepresentation" provides the appropriate focus for determining when the secondary actor "makes" a misrepresentation.

CONCLUSION

For the foregoing reasons, the Commission urges this Court to hold that a person who has the requisite scienter can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder when he or she, acting alone or with others, creates a misrepresentation, whether or not the person is identified with the misrepresentation by name.

Respectfully submitted,

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No. 98-783

In The

Supreme Court of the United States

October Term, 1998

IRENE L. WRIGHT, on behalf of herself and all others similarly situated,

Petitioner,

-v-

ERNST & YOUNG LLP,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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Pursuant to Rule 15.6 of the Rules of this Court, Petitioner Irene L. Wright respectfully submits this brief in reply to the Brief for the Respondent in Opposition filed with this Court on December 14, 1998 ("Res. Br.").

INTRODUCTION

First, in opposing petitioner's writ, respondent Ernst & Young LLP ("E&Y") argues that under any of the disparate tests applied by the various circuits for determining liability for secondary actors under the Securities and Exchange Act of 1934 (the "Exchange Act") interpreting *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), Ms. Wright's claim would be dismissed. Not only is this argument factually inaccurate (as discussed below), but respondent, in analyzing three of the different tests currently being applied respectively by three of the circuits to have considered this issue, has unwittingly highlighted the need for review by this Court.

Second, given respondent's acknowledgment of this clear conflict among the circuits, E&Y's assertion, made without any legal authority, that it is somehow too early for the Court to consider the issue because there is not yet sufficient confusion among the circuits is without merit. As several of this Court's prior decisions make clear, there is no established threshold for the number of circuits that must disagree on an issue before this Court will address conflicting interpretations of a question of law among the circuits. Indeed, the varying interpretations by the Second Circuit on the issue presented in this petition alone demonstrate that the time is ripe for clarification of this Court's decision in *Central Bank*.

Finally, conspicuous in its absence is any reference by respondent to the split among the circuits on the key issue of attribution. Indeed, respondent's failure to even attempt to reconcile the holdings of *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("a secondary actor cannot incur primary liability under the Act for a

statement not attributed to that actor"), and *Klein v. Boyd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136, at 90,324 (3d Cir. Feb. 12, 1998), *vacated, Klein v. Boyd* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,165 (3d Cir. Mar. 9, 1998) (liability may attach "even when the secondary actors are not identified to the investor"), undermines respondent's hypothesis that insufficient disagreement exists among the circuits for this Court to grant petitioner's writ.

ARGUMENT

I. Respondent Has Mischaracterized Petitioner's Factual Claims

As an initial matter, respondent's recitation of the facts on which it bases its argument that plaintiff cannot state a claim under any circuit's interpretation of *Central Bank* is inaccurate. Respondent asserts that petitioner's allegations concerned E&Y's recklessness in not discovering that "rogue employees of [BT Office Products International, Inc. ("BT")] had engaged in theft and fraud." Res. Br. at 3. This is not the gravamen of petitioner's claim nor is it the question reviewed by the Second Circuit below. Rather, petitioner claims that E&Y is culpable under Section 10(b) of the Exchange Act because it represented to management of BT that BT's 1995 year-end financial results were sufficiently accurate to disseminate to the public despite E&Y's knowledge of numerous unexplained "red flags" discovered in the course of its audit of BT, including a $3.9 million under-accrual in accounts payable at BT's New York Division. Although E&Y discovered this under-accrual in January of 1996, it failed to investigate further, concluding, without reasonable basis, that the under-accrual was not material because there had been a similar under-accrual the previous year. E&Y's conclusion, reported to management of BT, that the under-accruals somehow offset each other, was reckless in the extreme because, *inter alia*, E&Y had not even

audited BT's New York Division in 1994. Thus, E&Y had no idea whether the 1995 under-accrual had any relation to that of 1994.

Nevertheless, on January 22, 1996, having completed its audit field work for the 1995 fiscal year, the audit engagement partners from E&Y gave the Chief Financial Officer of BT, John McKiernan, their assurance that BT's 1995 financial results were accurate. E&Y knew at the time of the meeting that the purpose of BT's obtaining E&Y's assurance on the accuracy of the 1995 financial results was to immediately release them to the public. Based on E&Y's assurances, without which, according to Mr. McKiernan, the disclosure of the 1995 financial results would not have occurred, BT issued a press release on January 30, 1996, (the "January Press Release") announcing what were undisputedly materially inflated and false financial results. As a result, BT's share price rose nearly eight dollars during the following two months. When the inaccuracies of those financial results were revealed on March 28, 1996, the share price dropped nearly 25% in one day.

II. The Question Presented For Review Is Properly Before This Court

Resting on its mischaracterization of the facts, respondent argues that because the January Press Release does not recite E&Y's assurances to BT as to the accuracy of the 1995 financial results or BT's complete reliance on those assurances, E&Y's misstatements were not communicated to investors, and, thus, the question petitioner has presented for review is not raised in this case. Res. Br. at 7. A review of the January Press Release itself belies this assertion.

The January Press Release contains two parts: (1) a narrative description of BT's 1995 operations and the reasons for its 1995 financial results; and (2) the numerical financial results themselves, contained both in the body of the January Press Release and in an annexed

chart. It is the numerical results alone that petitioner contends are false and actionable, not the accompanying narrative. It is these numerical results that E&Y knew would be made public if, and only if, E&Y assured BT management that the results were sufficiently accurate such that any subsequent change in the year-end numbers would be immaterial. These figures and their dissemination were, thus, virtually the sole province of E&Y, with BT acting as a mere conduit to the investing public.

Respondent simply glosses over these allegations by asserting that the public never knew about E&Y's "private advice to its client." Res. Br. at 4. However, that is precisely the question raised by this petition – whether the investing public's lack of knowledge of the pivotal role of a secondary actor, like E&Y here, in the preparation and dissemination of false and misleading financial results that such secondary actor knew would be communicated to the public, shields that secondary actor from liability. This narrow attribution question is one over which the circuits have split, and is, therefore, properly before the Court at this time.

III. The *Klein* Decision Is Squarely At Odds With The Second Circuit

By ignoring the actual question presented by this petition, respondent avoids discussing the reasoning which has led to the split between the Second and Third Circuits regarding the need for attribution. Instead, it simply insists that the Third Circuit's ruling in *Klein* has no precedential value because it was vacated pending *en banc* review. In *Klein*, the Third Circuit sets forth a test that explicitly disagrees with the Second Circuit's holding in *Wright*. The *Klein* court found that attribution was irrelevant as long as the secondary actor "significantly participate[d] in the creation of their client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors. . . . " (CCH) ¶ 90,136 at 90,324. In

Klein, a law firm was subject to liability for its role in disseminating disclosure documents even though the firm was not identified in the documents. Clearly, given the undisputed facts here, E&Y could be deemed a co-author of the statement under the *Klein* test, since without its participation, no year-end financial results or commentary about those results would have been issued by BT.

The ultimate conclusion of the *en banc* panel in *Klein* will never be known, because the case has now been settled for an undisclosed amount.[1] However, this Court may take note of a vacated decision in its evaluation of a split among the circuit courts. In *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 305 (1985), this Court granted *certiorari* because "[t]he lower courts have divided over the proper scope of the *in pari delicto* defense in securities litigation." In coming to this conclusion, this Court cited a vacated case from the Fifth Circuit, *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975), *vacated and remanded on other grounds*, 426 U.S. 944 (1976). *See Bateman*, 472 U.S. at 305 n.10. *See also Basic, Inc. v. Levinson*, 485 U.S. 224, 247 n. 25 (1988) (noting a *vacated* Second Circuit decision in demonstrating consensus among circuit courts). Therefore, that the original Third Circuit panel's decision in *Klein* was vacated does not diminish in the least the evidence it provides of confusion among the circuits on the key attribution question. This Court may certainly consider that evidence in evaluating whether to grant a writ of *certiorari*.

Indeed, the district court for the Northern District of Georgia, foreshadowing events in the Eleventh Circuit, recently issued a decision which closely follows the reasoning in *Klein*. *See Carley Capital Group v. Deloitte & Touche, L.L.P.*, No. 1:97-CV-3183-TWT, slip op., (N.D. Ga.

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[1] Duffy, Shannon P., "Firm Settles; Ruling On SEC Act Stands," *The National Law Journal*, December 7, 1998 at A5.

Nov. 16, 1998) (set forth at 1a in Petitioner's Supplemental Brief To Petition For A Writ Of Certiorari ("Supp. Br."), filed with this Court on December 9, 1998). The *Carley Capital* court is the only court in the Eleventh Circuit to have discussed primary liability for secondary actors in the wake of *Central Bank*, and respondent's failure to address this case, or, for that matter, the SEC's *amicus curiae* brief (Supp. Br. at 38a), heavily relied upon by the *Carley Capital* court, is symptomatic of its refusal to address the actual issue presented by petitioner's writ.

IV. Respondent's Conduct Is Actionable Under The Ninth And Tenth Circuit Tests

Respondent also argues that this case should not be reviewed because under the facts presented here, E&Y could not be held liable under any of the different tests utilized by the other respective circuits that have considered the issue. However, respondent would not only be liable under the Third Circuit's *Klein* test, but would likely have been held liable under the other different tests interpreting *Central Bank* devised by the Ninth and Tenth Circuits. Importantly, all of these standards contradict at least one version of the Second Circuit's various tests.[2]

The Ninth Circuit in *In re Software Toolworks Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994), stated that a secondary actor could incur primary liability if that actor had played a "significant role" in the dissemination of misleading statements (the "substantial participation" test). In *Software Toolworks*, the accounting firm defendant was subject to liability where it had helped its client prepare two misleading letters to the Securities and Exchange Commission. Respondent asserts that the accounting firm's conduct in *Software Toolworks* went far beyond that of E&Y's alleged conduct here. Res. Br. at 10-11. That

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[2] For a discussion of the various Second Circuit rulings on this issue, *see* Petition for a Writ of Certiorari ("Petition") at 8-9.

assertion ignores petitioner's key allegations. Quite simply, *but for* E&Y's representations to BT, no public misrepresentation would have occurred at all, because the January Press Release would never have been issued. In fact, E&Y's participation in the dissemination of the false financial results to the public was not merely "substantial" or "significant," it was absolutely *definitive*. Differing sharply from the Second Circuit's decision here, *Software Toolworks* did not require direct attribution; the focus was on the *conduct* of the secondary actor, not its identification. Thus, E&Y, according to its own rendition of the facts, would be liable under the Ninth Circuit's test.

Respondent also asserts that the Tenth Circuit's decision in *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996), applies the same test as did the Second Circuit in this case (Res. Br. at 12), and therefore that petitioner's claims would fail under the Tenth Circuit's test. Respondent is wrong on both counts. For primary liability of a secondary actor to exist, both the Second Circuit in *Wright* and the Tenth Circuit in *Anixter* have held that there is no requirement that an alleged violator directly communicate with investors so long as the secondary actor knew or should have known that its representation would be communicated to investors. However, the Second Circuit's decision in *Wright* injected the additional condition that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination." Petition at 12a. It is the addition of this attribution element in the Second Circuit's interpretation of *Central Bank* (which is not found in *Anixter* and is, in fact, contradicted by *Klein*) which gives rise to this petition.

Respondent seizes on the phrase "his misrepresentation" in *Anixter* to support its conclusion that the Second Circuit and *Anixter* actually applied the same test, despite that the Second Circuit requires attribution and *Anixter* does not. Respondent essentially argues that the above

language in *Anixter* means that the exact misrepresentation of the secondary actor must be repeated by the primary actor. However, the *Anixter* court did not so hold. Rather, the court set forth a flexible standard, significantly different than that used by the *Wright* court (and also different from that in *Software Toolworks*) and one under which E&Y would likely have incurred primary liability here:

> Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver*, we conclude that in order for accountants to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will *reach* potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided "significant" or "substantial" assistance to the representations of others.

77 F.3d at 1226-27 (emphasis added).

The Tenth Circuit's use of the word "reach," and comment that this is not a bright line test, counsel against respondent's restrictive reading of *Anixter*. Since plaintiff has properly alleged that E&Y knew that its representations as to the accuracy of the false financial results would be communicated to the market through the public dissemination of these figures, E&Y would be liable under *Anixter*.

V. The Issue Raised In This Petition Is Ripe For Consideration By This Court

Respondent urges this Court to wait for lower courts to continue to consider the issue raised in this petition since "only" three circuit courts (respondent fails to include the vacated *Klein* decision, which would bring the

total to four) have done so thus far (Res. Br. at 16).[3] Petitioner disagrees. This Court has not made a practice of waiting for all circuits to weigh in on a question before clarifying its own decisions. Rather, it has been the practice of this Court to grant *certiorari* when important issues require clarification, without adhering to a rigid rule concerning the number of lower courts to address a particular issue.

In one leading securities case, *Basic, Inc. v. Levinson*, 485 U.S. 224, 230 (1988), this Court granted *certiorari* to resolve an issue, that had been addressed by only three circuit courts, concerning the proper materiality standard to be applied in securities cases. *See also Aaron v. Securities and Exchange Commission*, 446 U.S. 680 (1980) (split among two circuit courts and a district court on one issue and three circuit courts on another). In fact, this Court has granted *certiorari* in securities cases in the absence of a circuit split. *See, e.g., Dirks v. Securities and Exchange Commission*, 463 U.S. 646, 652 (1983) (in clarifying an earlier case, this Court stated that "[i]n view of the importance to the SEC and to the securities industry of the question presented by this case, we granted a writ of certiorari."). Further, respondent offers no countervailing authority illustrating a practice of this Court to await a specific number of circuit court decisions or a particular level of chaos or legal uncertainty within the federal judiciary before granting *certiorari*.

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[3] Notwithstanding respondent's assertion that this Court should not act as a watchdog over the Second Circuit's internal inconsistencies (Res. Br. at 15), the intra-circuit confusion in the Second Circuit is symptomatic of the confusion not only among, but within, the circuits concerning the limits of *Central Bank*. Respondent itself, in fact, admits that the issue of primary liability for secondary actors is "in a state of flux." Res. Br. at 16.

CONCLUSION

For the reasons set forth above and in petitioner's opening and supplemental briefs, petitioner submits that this case presents an ideal and necessary opportunity for this Court to clarify its holding in *Central Bank*.

Respectfully submitted,

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